No. 01-147-CFX Title: Securities and Exchange Commission, Petitioner
v.
Charles Zandford

Docketed: July 25, 2001 Court: United States Court of Appeals for the Fourth Circuit

Entry	Date	Proceedings and Orders
	Jan 7 2001	Order extending time to file respondent's brief on the merits to and including February 4, 2002.
	Jun 14 2001	Application (00A1099) to extend the time to file a petition for a writ of certiorari from June 24, 2001 to July 24, 2001, submitted to The Chief Justice.
	Jun 16 2001	Application (00A1099) granted by the Chief Justice extending the time to file until July 24, 2001.
	Jul 24 2001	Petition for writ of certiorari filed. (Response due September 24, 2001)
	Aug 13 2001	Order extending time to file response to petition until September 24, 2001.
	Sep 24 2001	Motion of respondent for leave to proceed in forma pauperis filed.
	Sep 24 2001	Brief of respondent Charles Zandford in opposition filed.
	Oct 9 2001	Reply brief of petitioner Securities and Exchange Commission filed.
	Oct 10 2001	DISTRIBUTED for Conference of October 26, 2001
	Oct 29 2001	REDISTRIBUTED for Conference of November 2, 2001
	Nov 8 2001	Motion of respondent for leave to proceed in forma pauperis GRANTED.
	Nov 8 2001	Petition GRANTED. SET FOR ARGUMENT March 18, 2002. **********
	Dec 10 2001	Motion of the Solicitor General to dispense with printing the joint appendix filed.
	Dec 21 2001	Brief amicus curiae of petitioner NASD Regulation, Inc. filed.
	Dec 26 2001	Brief of petitioner Securities and Exchange Commission filed.
	Dec 26 2001	Brief amici curiae of AARP, et al. filed.
	Jan 7 2002	Motion of the Solicitor General to dispense with printing the joint appendix GRANTED.
	Jan 23 2002	CIRCULATED.
	Feb 4 2002	Brief of respondent Charles Zandford filed.
	Feb 4 2002	Record filed.
	Feb 27 2002	Record filed.
	Mar 6 2002	Reply brief of petitioner Securities and Exchange Commission filed.
	Mar 18 2002	ARGUED.

Supreme Court, U.S.
FILED

01 147 JUL 24 2001

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No.

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
PETITIONER

v.

CHARLES ZANDFORD

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a stockbroker's fraud is "in connection with the * * * sale" of securities under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, when the stockbroker sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so.

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In the Supreme Court of the United States

No.

SECURITIES AND EXCHANGE COMMISSION,
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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Securities and Exchange Commission (SEC or Commission), respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-14a) is reported at 238 F.3d 559. The memorandum, order, and judgment of the district court granting the Commission's motion for summary judgment (App., *infra*, 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on January 26, 2001. A petition for rehearing was denied on March 26, 2001 (App., *infra*, 51a). On June 16, 2001, Chief Justice Rehnquist extended the time within which to file a petition for a writ of certiorari to and

including July 24, 2001. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE AND RULE INVOLVED

The texts of 15 U.S.C. 78j(b) and 17 C.F.R. 240.10b-5 are reproduced in Appendix G, *infra*, at 52a-53a.

STATEMENT

1. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device or contrivance in contravention of such rules and reglations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b) (*reprinted in* App., *infra*, 52a). SEC Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5 (*reprinted in* App., *infra*, 52a-53a).

2. In 1987, respondent Charles Zandford, a stockbroker, convinced William Wood to open a joint brokerage account for Wood and his daughter, Diane Wood Okstulski. Wood was an elderly man in poor health, and his daughter was both mentally retarded and mentally ill. Wood and Okstulski (the Woods) entrusted respondent with $419,255 to "conservatively invest" in his discretion. Respondent, however, methodically siphoned money from the Woods' investment account to accounts that respondent owned or controlled. Respondent did so by repeatedly selling securities in the Woods' account in order to acquire the proceeds. Respondent never disclosed his activities to the Woods. By September 1990, all of the Woods' funds were gone. App., *infra*, 2a, 10a, 28a-29a, 34a, 41a-42a.

In April 1995, a federal grand jury in the District of Maryland indicted respondent on thirteen counts of wire fraud in violation of 18 U.S.C. 1343. App., *infra*, 2a; see *id.* at 40a-50a (superseding indictment). The indictment charged respondent with "devis[ing] a scheme and artifice to defraud and to obtain money and property from [the Woods] by means of false and fraudulent pretenses, representations, and promises." *Id.* at 41a. Specifically, it alleged that respondent had "caused checks to be issued against the security positions of [the Woods] and made payable to [himself], thereby causing their securities to be liquidated." *Ibid.* The indictment also alleged that respondent "sold securities in [the Woods'] joint investment account, * * * and then made personal use of the money." *Id.* at 42a. A jury found respondent guilty of all of the wire fraud charges, and the district court sentenced respondent to a prison term of 52 months. *Id.* at 2a. The court of appeals, finding "ample direct and circumstantial evidence showing that [respondent] had engaged in a scheme to defraud the Woods" (*id.* at 36a), affirmed respondent's convictions and sentence. *Id.* at 33a-39a.

3. In September 1995, the SEC brought this civil law enforcement action against respondent in the United States District Court for the District of Maryland. App., *infra*, 25a-32a. The Commission's complaint alleged that, between May and June 1988, without the Woods' knowledge or consent, respondent issued

checks to himself drawn on the Woods' joint mutual fund account, and that the funds to pay the checks were obtained through the sale of mutual fund shares in that account. *Id.* at 28a. The complaint further alleged that, on several occasions between July 1988 and June 1990, respondent sold mutual fund shares or other securities owned by the Woods without their knowledge or consent and misappropriated the proceeds of the sales. *Id.* at 29a. The complaint charged that respondent thereby violated Section 10(b) and Rule 10b-5. *Id.* at 30a-31a.[1]

In April 1998, the Commission filed a motion for summary judgment in which it relied on the collateral estoppel effect of respondent's criminal convictions to establish that he intentionally defrauded the Woods. Respondent filed a motion to conduct discovery, but he did not move for summary judgment. In March 1999, the district court denied respondent's motion for discovery, granted the Commission's motion for summary judgment, enjoined respondent from future violations of the antifraud provisions, and ordered him to disgorge $343,000 in illegally obtained funds. App., *infra*, 3a, 15a-24a.

4. Respondent appealed. The United States Court of Appeals for the Fourth Circuit not only reversed the district court's grant of summary judgment in favor of the SEC, but also remanded the case with directions to dismiss the complaint. App., *infra*, 1a-14a. The court of

[1] The complaint also alleged that respondent violated Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a). App., *infra*, 25a, 30a-31a. We do not seek this Court's review, however, of the question whether the complaint stated a claim under Section 17(a) because we have not identified a square conflict between the decision of the court of appeals in this case and decisions of this Court or other courts of appeals on that question.

appeals observed at the outset that, even if "the criminal trial established the fact that [respondent] sold securities as part of a scheme to misappropriate proceeds," respondent's criminal convictions did not collaterally estop him from contesting the district court's "legal conclusion" that "such a scheme satisfies the 'in connection with' requirement" of Section 10(b). *Id.* at 5a. Reviewing that legal conclusion, the court of appeals held that respondent's "alleged fraudulent activities were not sufficiently connected to a securities transaction to merit liability under [Section] * * * 10(b)." *Id.* at 14a.

The court noted that, "to state a claim under § 10(b) of the Exchange Act and Rule 10b-5," the Commission must show that respondent's fraud was "in connection with" the purchase or sale of any security. App., *infra*, 6a (quoting 15 U.S.C. 78j(b)). The court concluded that the SEC had failed to make that showing because, in the court's view, respondent's "securities sales were incidental to his scheme to defraud. [Respondent's] fraud lay in absconding with the proceeds of the sales. The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion." *Id.* at 9a.

In explaining why it determined that respondent's conduct was not "in connection with" any securities transaction, the court stated that respondent's fraudulent "statements or omissions were not about a particular security" (App., *infra*, 13a), "did not make any reference to the attributes of a specific security" (*id.* at 10a), and did not "induce the Woods or anyone else to buy or sell a particular stock" (*id.* at 13a). The court also stated that "the goal of § 10(b) would not be served by expanding its scope to include 'claims amounting to breach of contract or common law fraud which have

long been the staples of state law.'" *Id.* at 8a (quoting *Hunt* v. *Robinson*, 852 F.2d 786, 787-788 (4th Cir. 1988)). The court concluded that, "while [respondent] breached a fiduciary duty to the Woods, the Supreme Court has emphasized that the federal securities laws are not an open-ended breach of fiduciary duty ban." *Id.* at 14a (citing *United States* v. *O'Hagan*, 521 U.S. 642, 655 (1997), and *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462 (1977)). In light of its conclusions, the court of appeals remanded the case to the district court "with directions to dismiss it." *Ibid.*

The court of appeals subsequently denied the Commission's petition for rehearing and rehearing en banc. App., *infra*, 51a.

REASONS FOR GRANTING THE PETITION

A stockbroker violates Section 10(b) when, without authorization or disclosure, he sells customer securities for his own benefit and uses the proceeds for himself. The contrary decision of the court of appeals conflicts with the decision of this Court in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), and with the decision of the United States Court of Appeals for the Ninth Circuit in *United States* v. *Kendrick*, 692 F.2d 1262 (1982), cert. denied, 461 U.S. 914 (1983). The decision below also conflicts with the interpretation of the securities laws reflected in over a half century of SEC decisions, and, if allowed to stand, it will significantly impair the Commission's ability to enforce those laws for the protection of investors. Review by this Court is therefore warranted.

1. The court of appeals erred in holding that respondent's alleged fraudulent conversion of the Woods' securities and the proceeds of the sales of those securities was not "in connection with" those sales in violation

of Section 10(b). Respondent's fraud was integrally connected to the securities sales because the sales were both the direct result of respondent's deception of the Woods and the means by which he accomplished the goal of his fraud—the conversion of their assets.[2]

Section 10(b) prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the Commission. 15 U.S.C. 78j(b). SEC Rule 10b-5 in turn prohibits "any person" from "employ[ing] any device, scheme, or artifice to defraud," or "engag[ing] in any act [or] practice" that "operates or would operate as a fraud or deceit upon any person," "in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5(a) and (c). Thus, Section 10(b) encompasses "(1) using any deceptive device (2) in connection with the * * * sale of securities." *United States* v. *O'Hagan*, 521 U.S. 642, 651 (1997).

The Commission's complaint in this case alleged that respondent, without the Woods' knowledge or consent, issued checks to himself drawn on a mutual fund account held by the Woods, and that the funds to pay the checks were obtained through the sale of mutual fund shares in that account. App., *infra*, 28a. The Commission further alleged that, on several occasions, respondent sold mutual fund shares or other securities owned by the Woods without their knowledge or

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[2] Because the court of appeals, rather than merely reversing the district court's grant of summary judgment, dismissed the Commission's complaint for failure to state a claim, this Court must assume that the allegations in the complaint are true and could affirm the dismissal only if the Commission could prove no set of facts that would entitle it to relief. See *Hartford Fire Ins. Co.* v. *California*, 509 U.S. 764, 811 (1993).

consent and misappropriated the proceeds of the sales. *Id.* at 29a. See also *id.* at 41a-42a (superseding indictment) (making similar allegations). That course of conduct establishes both elements of a Section 10(b) violation—(1) fraud (2) in connection with the sale of securities.

Fraud: That respondent defrauded the Woods is established by respondent's criminal convictions for wire fraud under 18 U.S.C. 1343. See *O'Hagan*, 521 U.S. at 654 (equating fraud under mail fraud statute with fraud under Section 10(b)). The Woods entrusted their assets to respondent for him to invest for their benefit. As their agent, respondent owed the Woods a duty of loyalty and had authority to use their assets only for their benefit and not to enrich himself. See Restatement (Second) of Agency § 387 (1958) ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."); App., *infra*, 14a (acknowledging that respondent "breached a fiduciary duty to the Woods"). When, without disclosure to the Woods, respondent acted beyond the scope of his authority and in breach of his duty of loyalty, respondent committed fraud. See *O'Hagan*, 521 U.S. at 653-654 ("A fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's [property] for personal gain' * * * 'dupes' or defrauds the principal.") (second brackets added); *Carpenter* v. *United States*, 484 U.S. 19, 27 (1987) ("The concept of 'fraud' includes the act of embezzlement, which is 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'") (quoting *Grin* v. *Shine*, 187 U.S. 181, 189 (1902)). Indeed, the court of appeals did not question that respondent engaged in fraud.

In connection with the sale of securities: Respondent's fraud was "in connection with" the sale of the Woods' securities because the sales were the means by which respondent accomplished the goal of his fraudulent scheme. The complaint alleged that checks that respondent issued to himself drawn on the Woods' mutual fund account triggered the sale of mutual fund shares in the account. App., *infra*, 28a. The complaint further alleged that, on repeated occasions, respondent sold mutual fund shares or other securities in the Woods' account, caused checks to be issued in the amount of the proceeds of the sales, and deposited those checks in accounts under his control. *Id.* at 29a. In those instances, as the complaint alleged, and the court of appeals assumed, the sales were the means by which respondent "generated" the cash that he stole. *Ibid.*; *id.* at 2a.

Respondent's fraud was also "in connection with" the sales of the Woods' securities because the sales were the direct result of his deception. If a broker who planned to sell his customer's securities for his own benefit disclosed his plans to the customer, the customer would take action to prevent the sales. The court of appeals thus erred in concluding that respondent's "security sales were incidental to his scheme to defraud." App., *infra*, 9a. On the contrary, the sales lay at the heart of respondent's fraudulent scheme.

This Court's decision in *O'Hagan* illustrates the court of appeals' error. O'Hagan committed fraud by stealing information entrusted to him by his employer, to which he owed a fiduciary duty, and using the information for personal profit by trading in securities. The Court held that his fraud was "in connection with" his securities transactions "because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential

information, but when, without disclosure to his principal, he uses the information to purchase or sell securities." *O'Hagan*, 521 U.S. at 656.

Respondent's fraud was even more closely connected to the purchase or sale of securities than O'Hagan's. First, respondent did not misappropriate information; he misappropriated securities and the proceeds of securities sales. Second, respondent deceived the owners of the securities, who were parties to the securities sales that he transacted. O'Hagan, on the other hand, deceived the owner of the confidential information, who was not a party to O'Hagan's securities transactions. See *O'Hagan*, 521 U.S. at 656 (holding that, under the misappropriation theory of insider trading, the securities transaction and the breach of duty to disclose coincide "*even though* the person or entity defrauded is not the other party to the [securities] trade" (emphasis added)). Because O'Hagan's fraud was "in connection with the purchase or sale" of securities, it follows *a fortiori* that respondent's fraud also had the required connection.[3]

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[3] The court of appeals attempted to distinguish *O'Hagan* as limited to insider trading. See App., *infra*, 11a. Nothing in *O'Hagan*, however, suggests that the Court's analysis of the "in connection with" requirement is limited to insider trading cases. The court of appeals also incorrectly suggested (*id.* at 12a) that this case is comparable to the hypothetical discussed in *O'Hagan* of someone who "defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities." *O'Hagan*, 521 U.S. at 656. The securities purchase in the hypothetical, however, was not necessary to or part of the fraud. In this case, in contrast, the securities transactions were integral to respondent's fraudulent scheme. Respondent could not have accomplished his fraud without the securities sales, which consummated the fraudulent conversion of the securities and generated the cash that he misappropriated.

O'Hagan also illustrates that the court of appeals erred in reasoning that respondent's fraud did not have the requisite connection to a securities transaction because his misrepresentations "were not about a particular security" (App., *infra*, 13a) and "did not make any reference to the attributes of a specific security" (*id.* at 10a). See *SEC* v. *Jakubowski*, 150 F.3d 675, 679 (7th Cir. 1998) (Easterbrook, J.) (explaining that *O'Hagan* demonstrates that the connection requirement does not limit Section 10(b) to misrepresentations about the value of securities), cert. denied, 525 U.S. 1103 (1999). The "in connection with" requirement does not limit the subject matter of prohibited misrepresentations. Rather, it demands a "connection"—a nexus—between the misrepresentation, whatever its subject matter, and the purchase or sale of any security. See *SEC* v. *Clark*, 915 F.2d 439, 449 (9th Cir. 1990); *Abrams* v. *Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 593 (7th Cir. 1984); *Brown* v. *Ivie*, 661 F.2d 62, 65 (5th Cir. 1981), cert. denied, 455 U.S. 990 (1982). The necessary connection exists "when [as in this case] the proscribed conduct and the sale are part of the same fraudulent scheme." *Alley* v. *Miramon*, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980) (Wisdom, J.).[4]

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[4] Courts of appeals have frequently found the "in connection with" requirement satisfied in cases in which the misrepresentation did not concern the attributes of a particular security. See *Press* v. *Chemical Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) (broker-dealer's failure to disclose to a customer purchasing a Treasury note that funds from the maturing note would not be available on the maturity date); *Jakubowski*, 150 F.3d at 679 (purchaser's misrepresentation of his identity); *Angelastro* v. *Prudential-Bache Sec., Inc.*, 764 F.2d 939 (3d Cir.) (misrepresentations about interest rates on a margin account), cert. denied, 474 U.S. 935 (1985); *Marbury Mgmt., Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.)

Finally, *O'Hagan* makes clear that the court of appeals also erred in reasoning that respondent's conduct did not have the requisite connection to a securities transaction because it was actionable under state law. See App., *infra*, 8a ("the goal of § 10(b) would not be served by expanding its scope to include claims amounting to breach of contract or common law fraud which have long been the staples of state law" (internal quotation marks and citation omitted)); *id.* at 14a (covering respondent's conduct under federal securities law would "subsume significant areas of state law"). In *O'Hagan*, this Court reiterated what it has held several times: the fact that there may also be liability under state law does not preclude liability under Section 10(b). See 521 U.S. at 655. Because Section 10(b) "trains on conduct involving manipulation or deception," a Section 10(b) action, like the one here, that is premised on deception presents no improper federalization of state law. *Ibid.* Compare *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1090-1095 & n.6 (1991) (securities fraud because there was deception), with *Santa Fe Indus.* v. *Green*, 430 U.S. 462, 474 (1977) (no securities fraud because there was full disclosure). In this case, "[s]ince there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under [Section] 10(b), whatever might be available as a remedy under state law." *Bankers Life*, 404 U.S. at 12; see also 15 U.S.C. 78bb(a)

(securities salesman's fraudulent representation that he was a licensed registered representative when he was a trainee), cert. denied, 449 U.S. 1011 (1980); *Arrington* v. *Merrill Lynch, Pierce, Fenner & Smith*, 651 F.2d 615 (9th Cir. 1981) (misrepresentation of the risks of buying securities on margin in a declining market); *Fey* v. *Walston & Co.*, 493 F.2d 1036 (7th Cir. 1974) (churning of customer accounts).

(1994 & Supp. V 1999) (Subject to limited exceptions not relevant here, "the rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity."); *Wharf (Holdings) Ltd.* v. *United Int'l Holdings, Inc.*, 121 S. Ct. 1776, 1782 (2001); *Basic Inc.* v. *Levinson*, 485 U.S. 224, 244 n.22 (1988).

2. a. This Court's review is warranted because the erroneous decision of the court of appeals conflicts with this Court's decision in *Bankers Life*, *supra*. In *Bankers Life*, the defendants led a company's board of directors to believe that the company would receive the proceeds from a proposed sale of Treasury bonds, when in fact the defendants intended to misappropriate the proceeds for their own use. 404 U.S. at 9. This Court reversed a decision of the Court of Appeals for the Second Circuit in which that court, much like the Fourth Circuit here, held that Section 10(b) did not apply to misappropriation of the proceeds of a sale of securities because "[t]here is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received." 430 F.2d 355, 360 (1970). This Court rejected that reasoning, holding that the "in connection with" requirement was satisfied when the board of directors was deceived about the reason for the sale of its securities, regardless of whether "the proceeds of the sale * * * were misappropriated." 404 U.S. at 10.

Although the Second Circuit in *Bankers Life* had acknowledged that, if the board had known that the defendants "intended to misappropriate the proceeds for their own use[,] it undoubtedly would not have authorized their sale," that court nonetheless held, like the Fourth Circuit in this case, that the fraud was not in

connection with the sale of a security. 430 F.2d at 360. As the Fourth Circuit did here, the court of appeals in *Bankers Life* reasoned that the "deception did not infect the subsequent sales transaction." 430 F.2d at 360. Compare App., *infra*, 9a ("The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion."). This Court rejected that reasoning, and held that, although "the full market price was paid for th[e] bonds," because the board had been "duped into believing that it * * * would receive the proceeds," "[w]e cannot agree * * * that the 'purity of the security transaction and the purity of the trading process were unsullied.'" 404 U.S. at 9-10.

The court of appeals in this case attempted to distinguish *Bankers Life* on the ground that, in that case, the defendants made a misrepresentation about a particular security that induced the sale of the security. App., *infra*, 13a. That purported distinction does not withstand scrutiny. Although *Bankers Life* may have involved a misrepresentation rather than, as in this case, silence in the face of a duty to disclose, the distinction is of no legal significance. Omissions are treated the same as false statements as long as there is a duty to disclose the information. See *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972) (finding liability under Section 10(b) even though "these defendants may have made no positive representation or recommendation. * * * The sellers had the right to know that the defendants were in a position to gain financially from their sales."); see also *Chiarella* v. *United States*, 445 U.S. 222, 228 (1980) ("the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them'") (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

Because respondent had a fiduciary duty to his customers, he also had a duty to disclose to them that he was going to sell the securities they had entrusted to him and use the proceeds for his own benefit. Further, as explained above, see p. 9, *supra*, respondent's failure to disclose his plans permitted him to carry out the sales, just as the misrepresentation in *Bankers Life* caused the directors to authorize the sale. Finally, the distinction drawn by the court of appeals cannot be justified on the ground that respondent's deception did not concern "a particular security" (App., *infra*, 13a) because the same is true of the deception in *Bankers Life*, and the scope of Section 10(b) is not restricted to misrepresentations about particular securities and their attributes, see p. 11, *supra*.

b. This Court's review is also warranted because the decision of the court of appeals conflicts with the decision of the Ninth Circuit in *United States* v. *Kendrick*, 692 F.2d 1262 (1982). In *Kendrick*, the court of appeals held that a stockbroker who converted to his own use money that he obtained from customer margin accounts that were secured by the pledge of securities engaged in fraud in connection with the sale of securities. *Id.* at 1264-1266. The stockbroker wrote checks payable to himself on the margin accounts, and those transactions were recorded as loans to the customers secured by the pledged securities. *Id.* at 1264. The court first explained that a pledge of securities to secure a loan is a sale of securities within the meaning of the securities laws. *Id.* at 1265. See *Rubin* v. *United States*, 449 U.S. 424, 431 (1981); *Mallis* v. *FDIC*, 568 F.2d 824, 829-830 (2d Cir. 1977), cert. dismissed, 435 U.S. 381 (1978). The court held that a sale of securities occurred each time a

check was issued, because the brokerage firm each time acquired an additional interest in the pledged securities. 692 F.2d at 1265. The court next explained that the broker engaged in fraud because he "failed to disclose to his customers * * * that he was acting beyond his authority in using customer funds for his own use." *Id.* at 1265-1266. Finally, the court concluded that the fraud was "in connection with" the sales because the broker was engaged in the fraud at the time he caused the brokerage firm to issue the checks on the margin accounts, which was the time at which the sales occurred. *Ibid.* Here, as in *Kendrick*, respondent was engaged in his fraudulent failure to disclose his intention to convert the Woods' assets when he issued the checks to himself that required the sale of the Woods' mutual funds, and when he sold other of the Woods' securities in order to steal the proceeds.[5]

The decision of the court of appeals in this case not only conflicts with the Ninth Circuit's decision in *Kendrick*, but its reasoning cannot be reconciled with decisions of other courts of appeals involving fraudulent conversions of securities. In *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1027-1029 (6th Cir. 1979), the court of appeals held that a brokerage firm violated Section 10(b) by fraudulently converting a customer's securities when it wrongfully refused to return bonds that the customer had earlier pledged to the firm as

[5] In *Pross* v. *Katz*, 784 F.2d 455 (1986), and *Flickinger* v. *Harold C. Brown & Co.*, 947 F.2d 595 (1991), the Second Circuit held that there was no violation of Section 10(b) when stock was fraudulently converted several months or years after its purchase. Even if those decisions were correct, they would not support the holding of the court of appeals in this case, because here respondent's fraudulent deception and the sale of the Woods' securities were simultaneous. See App., *infra*, 28a-29a.

collateral. Citing *Bankers Life*, the court concluded that "[t]he 'in connection with' requirement has easily been met." *Id.* at 1028. Moreover, in *Allico National Corp.* v. *Amalgamated Meat Cutters*, 397 F.2d 727 (7th Cir. 1968), which was cited with approval by this Court in *Bankers Life*, 404 U.S. at 10 n.7, the court of appeals held that the defendant's fraudulent conversion of the plaintiff's securities from an escrow account set up to implement a sale "quite clearly occurred 'in connection with' its transaction with plaintiffs." 397 F.2d at 729.

3. Finally, this Court should review and reverse the decision of the Fourth Circuit in this case because the decision conflicts with the SEC's longstanding and consistent interpretation of the securities laws, and because, if it is allowed to stand, it will significantly impair the Commission's ability to enforce those laws for the protection of investors. For over 50 years, the Commission has interpreted Section 10(b) and Rule 10b-5 to prohibit the fraudulent misappropriation of the proceeds of securities sales, and it has brought numerous injunctive and administrative actions to enforce that prohibition.[6]

There would be a serious gap in investor protection if the court of appeals' decision were allowed to stand and were followed by other courts. Brokers play a critical role in enabling the participation of investors in the

[6] See, *e.g.*, *Kenneth Leo Bauer*, 26 S.E.C. 770, 773-776 (1947); *D.S. Waddy & Co.*, 30 S.E.C. 367 (1949); *Southeastern Sec. Corp.*, 29 S.E.C. 609, 611-614 (1949); *Calvert Sec. Corp.*, 35 S.E.C. 141, 143 (1953); *Stuart F. Beck*, Exchange Act Release No. 19,916, 28 SEC Docket 303 (June 27, 1983); *SEC* v. *Faitos*, Litigation Release No. 12,786, 48 SEC Docket 528 (Feb. 27, 1991); *SEC* v. *Frank L. Harris*, No. CA 4:01CV117 (E.D. Tex. Apr. 6, 2001) (described in Litigation Release No. 16,954, 74 SEC Docket 2058 (Apr. 6, 2001)). *Cf. SEC* v. *Lawson*, 24 F. Supp. 360 (D. Md. 1938) (Section 17(a)).

securities markets, and frauds that impair customer assets erode investor confidence and undermine the operation of the markets. No other provision of the federal securities laws provides an equally effective alternative to Section 10(b) for bringing actions against stockbrokers who fraudulently misappropriate customer property.[7]

The decision of the court of appeals will be even more harmful if it is interpreted to mean that a deception must concern the "attributes of a particular security"

[7] Although Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), on which the Commission also relied below (see note 1, *supra*), also prohibits fraud in the sale of securities, the conduct at issue here would not be prohibited by Section 17(a) if it is not covered by Section 10(b). See *United States* v. *Naftalin*, 441 U.S. 768, 773 n.4 (1979). Section 15(c) of the Exchange Act, 15 U.S.C. 78o(c), prohibits brokers or dealers from engaging in fraudulent conduct "to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security," but that provision covers only securities traded in the over-the-counter market, not securities traded on exchanges. Section 21(d)(1) of the Exchange Act, 15 U.S.C. 78u(d)(1), authorizes the Commission, in some circumstances, to bring an injunctive action based on a violation of the rules of a securities industry self-regulatory organization, such as the National Association of Securities Dealers. Section 21(f), 15 U.S.C. 78u(f), however, makes clear that the Commission "shall not bring any action pursuant to subsection (d) * * * for violation of * * * the rules of a self-regulatory organization unless" the Commission finds that the self regulatory organization "is unable or unwilling to take appropriate action" or it is otherwise necessary or appropriate in the public interest for the Commission to bring such an action. The Commission also can bring administrative proceedings against brokerage firms and their personnel under Section 15(b)(4) and (6) and Section 21C of the Exchange Act, 15 U.S.C. 78o(b)(4) and (6), 78u-3, but only based on a violation of a provision of the securities laws, such as Section 10(b), or a criminal conviction.

(App., *infra*, 10a) to be "in connection with the purchase or sale of any security." Securities fraud—particularly by stockbrokers—often does not involve a misrepresentation about the attributes of a particular security. Deceptive conduct by brokers frequently includes churning customer accounts, misrepresentations about the qualifications of broker-dealers, and misrepresentations about the risks of margin accounts. Under the broader reading of the decision of the court of appeals, the Commission could not bring actions under Section 10(b) and Rule 10b-5 against persons who engage in such conduct—actions that are authorized and brought today under the law in other circuits. See note 4, *supra*.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JULY 2001

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 99-1733

SECURITIES & EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

CHARLES ZANDFORD, DEFENDANT-APPELLANT

[Argued: Oct. 30, 2000]
[Decided: Jan. 26, 2001]

Before WILKINSON, Chief Judge, and MICHAEL and TRAXLER, Circuit Judges.

OPINION

WILKINSON, Chief Judge:

Defendant Charles Zandford was convicted of thirteen counts of wire fraud for stealing from two of his investment clients. The Securities and Exchange Commission subsequently filed this civil action against Zandford under § 17(a) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and the SEC's Rule 10b-5. The district court granted the SEC's motion for summary judgment. Zandford now

appeals. We hold that the federal securities laws do not reach every claim for the theft or conversion of a security from a brokerage account. Because Zandford's fraudulent actions were not sufficiently connected with a securities transaction, we reverse the judgment of the district court and remand with directions to dismiss the case.

I.

Between 1987 and 1991, Charles Zandford worked as a securities broker. In 1987, Zandford persuaded William Wood to open a joint investment account for himself and his daughter, Diane Wood Okstulski. Wood was an elderly man who was in poor health. His daughter was mentally retarded and suffered from a multiple personality disorder. Zandford promised to "conservatively invest" the Woods' money. In total, the Woods entrusted Zandford with $419,255. By September 1990, all of it was lost.

In April 1995, a federal grand jury indicted Zandford on thirteen counts of wire fraud in violation of 18 U.S.C. § 1343. The indictment alleged that Zandford engaged in a scheme to defraud the Woods. The first count maintained that Zandford sold the Woods' shares of a mutual fund in order to use the proceeds for his own benefit. The remaining counts related to twelve separate checks from the Woods' account that Zandford made payable to himself. Zandford generated money in the Woods' account by selling their securities. A jury convicted Zandford on all counts. Zandford was sentenced to 52 months imprisonment and was ordered to pay $10,800 in restitution. This court subsequently affirmed Zandford's conviction. *See United States v. Zandford*, 110 F.3d 62 (4th Cir. 1997) (Table).

In September 1995, the Securities and Exchange Commission filed this civil action against Zandford under Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The SEC's complaint alleged that Zandford violated these laws by selling the securities in the Woods' account, by misappropriating $343,000 in proceeds, and by using the money for his own personal needs. The SEC sought to enjoin Zandford from further violating the federal securities laws and to recover Zandford's ill-gotten gains.

In April 1998, the SEC moved for partial summary judgment on its misappropriation claim. Zandford subsequently moved for permission to conduct limited discovery on the issue of whether his fraud was "in connection with" a securities transaction. On March 2, 1999, the district court denied Zandford's motion and granted the SEC's motion for summary judgment. The court determined that Zandford's criminal conviction for wire fraud established all facts necessary to satisfy the elements of the SEC's securities fraud claim. Therefore, the court held that the doctrine of collateral estoppel prevented Zandford from arguing that he was not civilly liable under the federal securities laws. The court enjoined Zandford from committing future violations of the securities laws. It also ordered Zandford to disgorge $343,000. Zandford now appeals.[1]

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[1] The SEC contends that Zandford's notice of appeal was untimely. Because the district court did not abuse its discretion when it construed Zandford's motion for reconsideration of the summary judgment order and subsequent letter as a motion for an extension of time, the notice of appeal was timely filed. *See*

II.

The district court determined that Zandford's criminal conviction for wire fraud established all facts necessary to satisfy the elements of the SEC's securities fraud claim. That court erred in holding that the doctrine of collateral estoppel prevented Zandford from contesting his civil liability under the federal securities laws.

A criminal conviction can prevent a party from relitigating issues in a subsequent civil proceeding. *See Emich Motors Corp. v. General Motors Corp.*, 340 U.S. 558, 568, 71 S. Ct. 408, 95 L.Ed. 534 (1951). For collateral estoppel to apply, the SEC must establish that: (1) the issue sought to be precluded is identical to one previously litigated; (2) the issue must have been actually determined in the prior proceeding; (3) determination of the issue must have been a necessary part of the proceeding; (4) the prior judgement must be final and valid; and (5) the party against whom estoppel is asserted must have had a full and fair opportunity to litigate the issue in the previous forum. *See Sedlack v. Braswell Services Group, Inc.*, 134 F.3d 219, 224 (4th Cir. 1998).

At the very least, the SEC's invocation of collateral estoppel fails to satisfy the "identity of issues" requirement. To establish that Zandford violated sections 17(a) and 10(b), the SEC must prove, *inter alia*, that Zandford committed fraud "in the offer or sale" of sec-

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Fed. R. App. P. 4(a)(5); *see also Thompson v. E.I. DuPont de Nemours & Co., Inc.*, 76 F.3d 530, 534 (4th Cir. 1996) (reviewing district court's determination of the existence of excusable neglect for abuse of discretion).

urities, or "in connection with the purchase or sale" of securities. *See* 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. By contrast, under the wire fraud statute, the government only need prove that (1) Zandford engaged in a scheme to defraud, and (2) that he used inter-state wire communications in executing his scheme. *See* 18 U.S.C. § 1343; *United States v. ReBrook*, 58 F.3d 961, 966 (4th Cir. 1995). Thus, to find Zandford guilty of wire fraud it was wholly unnecessary to determine whether his fraud was sufficiently connected to a securities transaction. Since Zandford was never charged with a criminal violation of § 10(b), he did not have the opportunity to argue at trial or on appeal that, as a legal matter, his fraud was not sufficiently connected to a securities transaction. The SEC concedes as much when it argues both that the criminal trial established the fact that Zandford sold securities as part of a scheme to misappropriate proceeds, and that the district court properly made a legal conclusion in this case that such a scheme satisfies the "in connection with" requirement. It is this legal conclusion which we will now review.

III.

A.

The Securities Act of 1933 was designed "to provide full and fair disclosure of the character of securities sold . . . and to prevent frauds in the sale thereof, and for other purposes." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 728, 95 S. Ct. 1917, 44 L.Ed.2d 539 (1975). Likewise, "the fundamental purpose of the Securities Exchange Act of 1934 [was] to implement a 'philosophy of full disclosure,' by providing participants in stock transactions with the information they need to

make their investment decisions." *Hunt v. Robinson*, 852 F.2d 786, 787 (4th Cir. 1988) (quoting *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-78, 97 S. Ct. 1292, 51 L.Ed.2d 480 (1977)) (citation omitted).

The federal securities laws do not cover all types of fraud. Rather, both the Securities Act and the Exchange Act require that the defendant's fraud be connected sufficiently to a securities transaction. To state a claim under § 17(a) of the Securities Act, the SEC must show that Zandford's fraud, misstatement, or omission occurred "in the offer or sale of any securities." 15 U.S.C. § 77q(a).[2] Likewise, to state a claim under § 10(b) of the Exchange Act and Rule 10b-5, the SEC must show, *inter alia*, that Zandford misrepresented or failed to state material facts "in connection with" the purchase or sale of a security. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.[3]

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[2] Section 17(a) of the Securities Act of 1933 provides:

> It shall be unlawful for any person in the offer or sale of any securities . . .
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a).

[3] Section 10(b) of the Exchange Act provides, in pertinent part, that:

The precise contours of the in connection with requirement are not self-evident. It seems unavoidable "that the standard be fleshed out by a cautious case-by-case approach." *See Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942-43 (2d Cir. 1984) (*quoting Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 (5th Cir. 1974)). While the in connection with requirement must be flexible, it is not so elastic as to cover incidents which bear no relationship to market integrity or investor understanding. In particular, it is clear that ordinary state law fraud or conversion claims

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> It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security [,] . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

Rule 10b-5, promulgated by the SEC pursuant to section 10(b), provides, in relevant part, that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . .
>
> (a) [t]o employ any device, scheme, or artifice to defraud, [or] . . .
>
> (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. Liability under Rule 10b-5 does not extend beyond conduct encompassed by § 10(b)'s prohibition. *See United States v. O'Hagan*, 521 U.S. 642, 651, 117 S. Ct. 2199, 138 L.Ed.2d 724 (1997).

do not invariably violate the federal securities laws. "Congress, in enacting the securities laws, did not intend to provide a federal remedy for all common law fraud." *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241 (4th Cir. 1988) (*citing Marine Bank v. Weaver*, 455 U.S. 551, 556, 102 S. Ct. 1220, 71 L.Ed.2d 409 (1982)). Indeed, the goal of § 10(b) would not be served by expanding its scope to include "claims amounting to breach of contract or common law fraud which have long been the staples of state law." *Hunt*, 852 F.2d at 787-88. With these principles in mind, we turn to the merits of Zandford's appeal.

B.

The precise issue before us is whether Zandford's alleged fraud is sufficiently connected to a securities transaction, as required by § 17(a) of the Securities Act, § 10(b) of the Exchange Act, and Rule 10b-5. The SEC advocates a very broad reading of the in connection with requirement. It alleges that Zandford defrauded the Woods by failing to inform them that he intended to sell their securities in order to obtain the proceeds for himself. The SEC argues that this omission was fraudulent since Zandford, as the Woods' investment adviser, bore a duty to disclose material information to the Woods. The SEC contends that Zandford's omissions were in connection with Zandford's sale of the securities in the Woods' account.

We do not believe that the federal securities laws extend to Zandford's fraudulent activities. The SEC has alleged what amount to ordinary state law fraud and conversion claims. In order to satisfy the in connection with requirement, "the fraud must have been integral to the plaintiff's purchase or sale of the

security." *Flickinger v. Harold C. Brown & Co., Inc.*, 947 F.2d 595, 598 (2d Cir. 1991); *see also Taylor v. First Union Corp. of South Carolina*, 857 F.2d 240, 245 (4th Cir. 1988) (holding that deception that is only "tangentially and incidentally" related to the sale of a security does not satisfy the in connection with requirement). We have found no violation of § 10(b), for example, where "[t]he alleged fraud lies, not in the actual sale of the stock, but rather in defendants' refusal to tender the shares as required by the terms of the [employment] contract." *Hunt*, 852 F.2d at 787. Here, Zandford's securities sales were incidental to his scheme to defraud. Zandford's fraud lay in absconding with the proceeds of the sales. The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion.

It is the SEC's burden to identify a fraudulent act and a particular sale of securities that would satisfy the in connection with requirement. This it has failed to do. Neither Zandford's inducements to open the brokerage account, nor his failure to inform the Woods that he intended to convert their assets, are sufficiently connected to a particular securities transaction. To take the opening of the account first, there is no allegation that Zandford's inducements influenced any investment decision by the Woods other than to initially open their brokerage account. It is not even alleged that Zandford misled the Woods about the relative merits or value of particular securities. *See Bochicchio v. Smith Barney, Harris Upham & Co., Inc.*, 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986) (holding that where the defendant promised to safely manage plaintiffs' investment account but later made unauthorized sales of plaintiffs' securities and converted the proceeds, the defendant's

fraudulent activity was merely a conversion of funds that did not satisfy the in connection with requirement); *Bosio v. Norbay Securities, Inc.*, 599 F. Supp. 1563, 1566-68 (E.D.N.Y. 1985) (holding that where defendant promised to forward proceeds to plaintiffs after a stock sale but then misappropriated the proceeds, plaintiffs had stated a conversion claim, not a §10(b) violation). Finally, the SEC never contended either in briefing or argument that the Woods' brokerage account was anything other than a discretionary one, in which Zandford could trade securities without first having to gain the Woods' approval.

Where, as here, the inducements to open an investment account did not involve the sale or purchase of any security, any misrepresentations resemble more an actionable state law fraud than a federal securities violation. Zandford's statements did not make any reference to the attributes of a specific security. As such, they are little different from fraudulent misstatements made, for example, in the process of securing a personal loan. The mere "intent to cause a conversion of ownership interests at some uncertain future time and through uncertain means does not bring federal law into play, even though that intent is held at the time a purchase or sale of securities occurs." *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986); *see also Head v. Head*, 759 F.2d 1172, 1175-76 (4th Cir. 1985) (holding that in order to satisfy the in connection with requirement, the fraud must relate to the securities alleged to satisfy the purchase and sale requirement, and not just to the transaction in its entirety); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984) (same).

The SEC next contends that the federal securities fraud laws apply to Zandford's misappropriation of the proceeds in the Woods' account. The SEC has advanced but one case in which a court has held that a broker who sells securities and misappropriates the proceeds has violated the federal securities laws, and that decision provides no analysis to support its holding. *See Henricksen v. Henricksen*, 486 F. Supp. 622, 629 (E.D. Wis. 1980). The SEC relies instead on *United States v. O'Hagan*, 521 U.S. 642, 117 S. Ct. 2199, 138 L.Ed.2d 724 (1997), to support its broad interpretation of the in connection with requirement. Specifically, the SEC argues that *O'Hagan* held that a defendant's misrepresentations do not have to induce investors to engage in a particular securities transaction in order to violate the federal securities laws.

We do not think, however, that *O'Hagan* controls this case. While *O'Hagan* certainly expanded the scope of the in connection with requirement, it did so in a specific context—namely, in those cases where someone traded securities based upon misappropriated confidential information. *O'Hagan* held that an attorney committed fraud in connection with a securities transaction when he misappropriated inside information from his client in order to engage in securities transactions based on this inside information. *O'Hagan*, 521 U.S. at 659, 117 S. Ct. 2199. Important to the Supreme Court's decision was the fact that the misappropriated confidential information had independent value to the client. *Id.* at 652, 656, 117 S. Ct. 2199. The defendant's actions limited the client's opportunity to profit from this information. By contrast, in this case, the Woods did not possess any inside information which would allow them to earn profits in the securities markets.

O'Hagan in fact took pains to limit the extent to which it expanded the scope of the in connection with requirement. It did not graft a generalized prohibition against breaches of fiduciary duty onto the securities laws. *See O'Hagan*, 521 U.S. at 655, 117 S. Ct. 2199. The Court also noted, with apparent approval, the government's contention that § 10(b) would not apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities. *Id.* at 656-57, 117 S. Ct. 2199. There would be no violation in such a case because the embezzled proceeds "would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained." *Id.* (internal citations omitted). The same logic applies to Zandford's fraudulent conduct. Unlike the defendant in *O'Hagan*, Zandford's goal was not to gain guaranteed profits through the purchase or sale of securities. Rather, his scheme was simply to steal the Woods' assets. *Id.* at 656, 117 S. Ct. 2199. Like the money an embezzler would use to buy securities, the money in the Woods' account had "value to [Zandford] apart from [its] use in a securities transaction." *Id.*

The question is not how Zandford stole the money in the Woods' account. Rather it is whether Zandford engaged in manipulation of a particular security. Zandford's wrongdoing reflects less a federal securities violation and more a state law tort of conversion. The misappropriated proceeds might as well have come from the unlawful sale of a car which the Woods had entrusted to Zandford's care.

The other cases upon which the SEC relies serve to underscore our point. In each of these cases, the defendants made misrepresentations about a particular security that induced another party either to purchase or sell that security. For instance, in *United States v. Naftalin*, 441 U.S. 768, 99 S. Ct. 2077, 60 L.Ed.2d 624 (1979), Naftalin's securities brokers sold particular securities based on Naftalin's false statements that he owned shares of those securities. Likewise, in *Superintendent of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6, 9, 92 S. Ct. 165, 30 L.Ed.2d 128 (1971), the defendants, in order to induce a company's Board of Directors to sell certain bonds, falsely told the Board that the company would receive the proceeds of the sale. In *SEC v. Jakubowski*, 150 F.3d 675 (7th Cir. 1998), Jakubowski made false statements on a stock subscription form in order to induce an issuer of securities to accept Jakubowski's offer to buy them. *Id.* at 679. Finally, in *Press v. Chemical Inv. Services Corp.*, 166 F.3d 529, 533 (2d Cir. 1999), the defendants failed to disclose that the funds from a maturing T-bill would not be available on a particular maturity date. This omission meant that the defendants had misrepresented the security's yield, which had affected the plaintiff's decision to purchase the particular security. In contrast to each of these cases, Zandford's statements or omissions were not about a particular security. Nor did his omissions induce the Woods or anyone else to buy or sell a particular stock.

We do not, of course, condone Zandford's misconduct. For his transgressions, Zandford was criminally convicted and he doubtless faces other forms of civil liability and professional sanctions. The fact that Zandford's actions were reprehensible, however, does not

relieve us of the obligation to determine whether his conversion of the Woods' assets violated the federal securities laws. We hold that Zandford's alleged fraudulent activities were not sufficiently connected to a securities transaction to merit liability under sections 17(a) and 10(b), and Rule 10b-5. Rather, the "only connection with federal securities laws is that the funds were converted from a securities investment account." *Smith v. Chicago Corp.*, 566 F. Supp. 66, 70 (N.D. Ill. 1983). The fact that Zandford's conduct as a broker may be within the scope of the securities statutes does not mean that his activities here necessarily constituted fraud in connection with a securities transaction. And while Zandford breached a fiduciary duty to the Woods, the Supreme Court has emphasized that the federal securities laws are not an open-ended breach of fiduciary duty ban. *See O'Hagan*, 521 U.S. at 655, 117 S. Ct. 2199 (citing *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 97 S. Ct. 1292, 51 L.Ed.2d 480 (1977)). In sum, we decline to stretch the language of the securities fraud provisions to encompass every conversion or theft that happens to involve securities. *See Pross*, 784 F.2d at 459. This would be tantamount to endorsing an all-purpose expansion of those statutes which would violate Congress' intent and subsume significant areas of state law.

IV.

For the foregoing reasons, the judgment of the district court is reversed, and the case is remanded with directions to dismiss it.

REVERSED and REMANDED.

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

Civil No. AMD 95-2826

SECURITIES & EXCHANGE COMMISSION, PLAINTIFF

v.

CHARLES ZANDFORD, DEFENDANT

[Filed: Mar. 2, 1999]

MEMORANDUM

The Securities and Exchange Commission instituted this action against Charles Zandford, a stock broker, under § 20(b) of the Securities Act of 1933 and §§ 21(d) & (e) of the Securities Act of 1934. In July 1995, Zandford was convicted by a jury in this court of 13 counts of wire fraud in violation of 18 U.S.C. § 1343. In September 1995, he was sentenced to a 52 month period of incarceration. The gravamen of his scheme was to obtain from his two victims in excess of $343,000 for the purpose of operating an investment brokerage account. The jury found, as the indictment alleged and the government's proof at trial established, that Zandford looted the account through fraudulent and unauthorized withdrawals from 1987 through 1991.

On April 3, 1997, the United States Court of Appeals for the Fourth Circuit affirmed Zandford's conviction

and sentence. *United States v. Zandford*, 110 F.3d 62 (4th Cir. 1997) (unreported), 1997 WL 153822 (4th Cir. April 3, 1997).[1]

Plaintiff has filed a motion for summary judgment based on issue preclusion. Zandford has responded with a request to take discovery on the issue of whether his fraudulent scheme was perpetrated "in connection with" securities transactions. I agree with the Plaintiff that the criminal judgment of conviction established that element (and all the elements) of Plaintiff's claim. As one court has observed:

> In a number of cases, the SEC has revoked the registration of brokers who converted money entrusted to them for the purpose of buying stock, or who sold a customer's stock and diverted the proceeds to their own pockets. In these proceedings, such activity has been consistently viewed by the SEC as a violation of Section 10(b) and Rule 10b-5. *Calvert Sec. Corp.*, 35 S.E.C. 141 (1953); *W.F. Coley & Co.*, 31 S.E.C. 722 (1950); *D.S. Waddy & Co.*, 30 S.E.C. 367 (1949). In *SEC v. Kelly*, CCH Fed. Sec. L.Rep. ¶ 90, 497 (N.D. Ill. 1951), the Court

[1] Zanford has been active litigant before and during his incarceration. *See e.g., Zandford v. National Ass'n of Securities Dealers, Inc.*, 30 F. Supp. 2d 1 (D.D.C. 1998); *Zandford v. National Ass'n of Securities Dealers, Inc.*, 19 F. Supp. 2d 1 (D.D.C. 1998); *Zandford v. National Ass'n of Securities Dealers, Inc.*, 19 F. Supp. 2d 4 (D.D.C. 1998); *Zandford v. Prudential-Bache Securities, Inc.*, 112 F.3d 723 (4th Cir. 1997); *Zandford v. Prudential-Bache Securities, Inc.*, 111 F.3d 963 (D.D.C. 1998) (table); *Zandford v. Prudential-Bache Securities, Inc.*, 1995 WL 507169 (D.D.C. Aug. 15, 1995); *Zandford v. Prudential-Bache Securities, Inc.*, 1994 WL 150918 (D. Md. Feb. 22, 1994); *Zandford v. National Ass'n of Securities Dealers, Inc.*, 1993 WL 580761 (D.D.C. Nov. 5, 1993).

> found a violation of Section 10(b) and Rule 10b-5 where it appeared that the defendant broker took money from customers for security purchases and used it for his own benefit. *See also SEC v. Lawson*, 24 F. Supp. 360 (D. Md. 1938) (conversion of customer's securities by broker defendant violated Section 17 of the Securities Act of 1933); *see generally* 2 Loss, *Securities Regulation* 1185-86 n.9, 1200 n. 41 (1961).

Cooper v. North Jersey Trust Co., 226 F.Supp. 972, 978 (S.D.N.Y. 1964). Accordingly, as a matter of law, Zandford's scheme violated the securities laws invoked here. Moreover, under settled principles of issue preclusion, *see Montana v. United States*, 440 U.S. 147, 153 (1979); *SEC v. Everest Management Corp.*, 466 F. Supp. 167, 172 (S.D.N.Y. 1979), Zandford is precluded from relitigating any of the elements of Plaintiff's civil claim under the securities laws.

Furthermore, despite Zandford's representation that he has no plans to work in the securities industry, Plaintiff is plainly entitled to the equitable relief it seeks as a matter of law, including an injunction and an order for disgorgement. *See Department of Housing & Urban Development v. Cost Control Marketing & Sales Management of Virginia, Inc.*, 64 F.3d 920, 927 (4th Cir. 1995) (citing with approval *S.E.C. v. First City Financial Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989) ("Disgorgement is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws."), *cert. denied sub. nom. Cost Control Marketing & Sales Management of Virginia, Inc. v. Cisneros*, 517 U.S. 1187 (1996).

At sentencing in the criminal case, Judge Nickerson ordered restitution in the amount of $10,800. The Commission shall credit that amount against the disgorgement order entered here. Moreover, I am not persuaded that prejudgment interest is appropriate under the circumstances of this case, in light of the more than four year period of incarceration imposed upon Zandford, during which the Court stayed this litigation. Thus, prejudgment interest is not awarded.

For the reasons stated, the Court will enter, as modified, the Order Proposed by the Plaintiff.

Filed: March 2, 1999 /s/ ANDRE M. DAVIS
ANDRE M. DAVIS
United States District Judge

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

Civil No. AMD 959-2826

SECURITIES & EXCHANGE COMMISSION, PLAINTIFF

v.

CHARLES ZANDFORD, DEFENDANT

[Filed: Mar. 2, 1999]

ORDER

In accordance with the foregoing Memorandum, it is this 2nd day of March, 1999, by the United States District Court for the District of Maryland, ORDERED

(1) That Plaintiff's motion for partial summary judgment (Paper # 15-1 and 15-2) is GRANTED IN PART and Defendant's motion for discovery and to extend time (Paper # 16 and # 18) are DENIED; and it is further ORDERED

(2) That the Clerk shall REOPEN THIS CASE, ENTER THE JUDGMENT ORDER ATTACHED HERETO AS A FINAL JUDGMENT WITHIN THE MEANING OF FED. R. CIV. P. 58, AND CLOSE THIS CASE; and it is further ORDERED

(3) That the Clerk shall TRANSMIT a copy of the foregoing Memorandum, this Order and the accompanying "Final Partial Judgment" to the attorneys for Plaintiff and to Defend, pro se.

/s/ ANDRE M. DAVIS
ANDRE M. DAVIS
United States District Judge

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

Civil No. (AMD) 95-CV-2826

SECURITIES & EXCHANGE COMMISSION, PLAINTIFF

v.

CHARLES ZANDFORD, DEFENDANT

[Filed: Mar. 2, 1999]

FINAL PARTIAL JUDGMENT

It appearing to this Court that Plaintiff Securities and Exchange Commission ("Commission"), having duly commenced this action by filing its Complaint ("Complaint") against defendant Charles Zandford ("Zandford"), defendant Zandford having filed a reply thereto; the Commission having moved this Court for an Order granting partial summary judgment, permanent injunction, disgorgement (with prejudgment interest) against defendant Zandford; the parties having submitted memoranda and other materials in support of and in opposition to the motion, the Court having jurisdiction over the parties and the subject matter of this action, and the Court being fully advised of the premises, the Court finds the following:

On July 25, 1995, a jury sitting in the United States District Court for the District of Maryland convicted Zandford of wire fraud in violation of 18 U.S.C. § 1343. (*U.S. v. Charles Zandford*, Criminal No. WN-94-0165).

The Court further finds that defendant Zandford's criminal conviction was based on the same facts alleged by the Commission against Zandford in its Complaint concerning misappropriations, and that Zandford is therefore collaterally estopped from relitigating the facts underlying his conviction.

The Court further finds that defendant Zandford's conviction establishes that he has engaged in violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder.

The Court further finds that there is a reasonable likelihood that defendant Zandford will violate these provisions of the federal securities laws in the future.

The Court further finds that the pleadings and other materials on file show that there is no genuine issue as to any material fact underlying the Commission's claim against defendant Zandford based upon misappropriations, the Commission is entitled to a judgment against Zandford on this claim as a matter of law under Fed. R. Civ. P. 56(c), and that an injunction should be issued against defendant Zandford based on these findings.

The Court further finds that defendant Zandford received $343,000 as a result of his illegal misappropriation of funds held in a brokerage account; and that he should be ordered to disgorge this amount, plus pay prejudgment interest of $309.406 [*sic*] thereon.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the Commission's Motion for Partial Summary Judgment, Permanent Injunction, and Disgorgement plus prejudgment interest against defendant Zandford is hereby granted.

II.

IT IS FURTHER ORDERED THAT:

Zandford, his agents, officers, servants, employees, attorneys, and those persons in active concert or participation with them, directly or indirectly, singly or in concert, who receive actual notice of this Order by personal service or otherwise, are permanently enjoined from making use of any means or instruments of transportation or communication in interstate commerce, or any means or instrumentality of interstate commerce, or of the mails, or any facility of any national securities exchange, in connection with the purchase or sale of any security to:

(a) employ any device, scheme or artifice to defraud;

(b) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading; or

(c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person;

in violation of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder.

III.

IT IS FURTHER ORDERED THAT:

Zandford shall pay disgorgement in the amount of $343,000 to the Clerk of the Court within thirty (30) days of the entry of this Order. Payment shall be made consistent with instructions to be provided by the Commission. Said disgorgement funds shall be distributed in accordance with a plan of disgorgement agreeable to the Commission and the Court.

February 25, 1999 /s/ Andre M. Davis
Date United States District Judge

APPENDIX C

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

Civil Action No. AMD-95-2826

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

CHARLES ZANDFORD, DEFENDANT

[Filed: Sept. 22, 1995]

COMPLAINT

Plaintiff Securities and Exchange Commission ("Commission") alleges for its Complaint the following:

1. Defendant Charles Zandford ("Zandford") has engaged in acts, transactions, practices and courses of business which constitute violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, thereunder.

JURISDICTION AND VENUE

2. The Commission brings this action pursuant to Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), and Sections 21(d) and 21(e) of the Exchange Act, 15 U.S.C. 78u(d) and 78u(e), to enjoin such acts, transactions,

practices and courses of business alleged herein, and for other relief.

3. The Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act, 15 U.S.C. 77v(a), and Section 27 of the Exchange Act, 15 U.S.C. 78aa.

4. Venue is proper in this district pursuant to Section 22(a) of the Securities Act, 15 U.S.C. 77v(a), and Section 27 of the Exchange Act, 15 U.S.C. 78aa, inasmuch as certain of the acts and practices constituting the violations alleged herein occurred within the District of Maryland and elsewhere.

5. Unless permanently restrained and enjoined by this Court, defendant Zandford will continue to engage in the same and similar transactions and courses of business alleged herein.

THE DEFENDANT

6. Charles Zandford is a resident of Maryland. During all times relevant to this Complaint, Zandford was a stockbroker in the Bethesda, Maryland branch office of Dominick and Dominick, Inc. ("Dominick"), a broker-dealer registered with the Commission.

7. On July 24, 1995, Zandford was found guilty by a jury sitting in the United States District Court for the District of Maryland on thirteen counts of wire fraud, based on the conduct described in this Complaint. (*United States* v. *Zandford*, Criminal Action No. WN-94-0165).

FACTS

Summary

8. Between November 1987 and August 1990, while employed as a stockbroker at Dominick, Zandford engaged in a scheme to defraud his largest brokerage customer, William R. Wood ("Wood"), of his life savings.

9. Wood, then an elderly man with physical and mental disabilities, held a joint account at Dominick with his daughter, Diane Wood Okstulski ("Okstulski"). (This account is referred to hereinafter as the Wood/Okstulski account.) Okstulski is mentally retarded and suffers from various psychological disorders.

10. Zandford misappropriated approximately $343,000 from Wood and Okstulski by liquidating, without their knowledge and consent, securities in their Dominick account, as well as mutual fund shares they held outside of the Dominick account. Zandford also received approximately $24,000 in commissions by excessively trading securities in the Wood/Okstulski account.

Background

11. In September 1987, Wood opened a joint account with Zandford at Dominick on behalf of Okstulski and himself, making an initial deposit of approximately $130,000. Wood's stated investment objectives for the account were "safety of principal and income."

12. In March 1988, Wood gave Zandford an additional $289,000 to deposit in the Wood/Okstulski account.

13. At the time Wood opened his brokerage account with Zandford, he was in poor mental and physical health. He had been on total disability from the government due to a head injury suffered twenty-three years earlier. Wood's physical and mental condition deteriorated during the period alleged herein. In April 1988, Wood suffered a stroke and was hospitalized. Wood spent the majority of the remainder of his life in nursing homes.

14. Wood died in a nursing home in December 1991, at the age of 76. At the time of Wood's death, there were no securities or funds remaining in the Wood/Okstulski account, as a result of Zandford's fraudulent conduct described below.

Misappropriation

15. Between May 1988 and June 1990, Zandford misappropriated approximately $343,000 from Wood and Okstulski in the manner set forth below.

16. Zandford's fraudulent scheme began in May 1988, shortly after Wood was hospitalized as a result of his stroke. Between May and June 1988, Zandford, without the prior knowledge or consent of Wood and Okstulski, issued three checks to himself totalling $41,000. The checks were drawn on a joint mutual fund account held by Wood and Okstulski outside of their Dominick account, and the funds represented therein were obtained through the sale of mutual fund shares in that account.

17. In July 1988, Zandford, without the prior knowledge or consent of Zandford, sold three securities in the Wood/Okstulski account for a total of $145,000. Zandford then obtained a check from Dominick in that amount and deposited it into a bank account under his control.

18. Between July 1989 and June 1990, Zandford misappropriated an additional $157,000 from Wood and Okstulski. On ten occasions during this period, Zandford caused mutual fund shares held by Wood and Okstulski in mutual fund accounts held outside of their Dominick account to be sold, and the resulting proceeds to be paid into the Wood account at Dominick. Zandford obtained approximately $111,000 in this manner. Zandford generated the remaining approximately $46,000 by selling securities in the Wood/Okstulski account. As the above proceeds were deposited into the Wood/Okstulski account, Zandford caused Dominick to issue checks made payable to Wood and Okstulski in amounts which corresponded with these transactions. Zandford then obtained the checks and deposited them into one of three bank accounts in his name or under his control. Zandford acquired the above funds without the prior knowledge or consent of Wood and his daughter.

19. Zandford used at least $64,000 of the misappropriated funds to purchase securities for his girlfriend's brokerage account at Dominick. All of the funds deposited in Zandford's girlfriend's account were later paid to Zandford at his request. Zandford used the remainder of the misappropriated funds to pay personal expenses including credit card debt and bank loans.

Excessive Trading

20. In addition to the above described misappropriation, Zandford also excessively traded securities in the Wood/Okstulski account.

21. Between November 1987 and August 1988, and February 1990 and July 1990, Zandford made all trading decisions in the Wood/Okstulski account.

22. Between November 1987 and August 1988, Zandford, with the intent to deceive, excessively traded securities in the Wood/Okstulski account. As a result of this conduct, Zandford generated gross commissions of approximately $37,000, of which he received approximately $23,000.

23. Between February 1990 and July 1990, Zandford, with the intent to deceive, excessively traded securities in the Wood/Okstulski account. As a result of this conduct, Zandford generated gross commissions of approximately $3,000, of which he received approximately $1,000.

CLAIM

Violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder

24. Paragraphs 1 through 23 are realleged and incorporated herein by reference.

25. From in or about 1987 through in or about 1991, defendant Zandford, in connection with the offer, purchase or sale of securities, directly and indirectly, by use of the means and instruments of transportation or

communication in interstate commerce, or the means and instrumentalities of interstate commerce, or the mails, or the facilities of a national securities exchange:

(a) employed devices, schemes or artifices to defraud;

(b) obtained money or property by means of, and made, untrue statements of material fact, or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(c) engaged in acts, transactions, practices, or courses of business which operated as a fraud and deceit upon offerees, purchasers or sellers of securities.

26. As part of and in furtherance of this conduct, defendant Zandford misappropriated funds from Wood and Okstulski, and excessively traded securities in the Wood account, as described in this Complaint.

27. By reason of the foregoing, defendant Zandford violated Section 17(a) of the Securities Act, 15 U.S.C. 77q(a); Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b); and Rule 10b-5, 17 C.F.R. 240.10b-5, thereunder.

WHEREFORE, the Commission respectfully requests that this Court:

I.

Issue an injunction permanently enjoining defendant Zandford, his agents, officers, servants, employees, attorneys, and those persons in active concert or participation with them, directly or indirectly, singly or in

concert, from violations of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a); Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b); and Rule 10b-5, 17 C.F.R. 240.10b-5, thereunder.

II.

Issue an order directing defendant Zandford to make disgorgement of any unlawfully obtained proceeds which he received as a result of the fraudulent conduct described in this Complaint, together with prejudgment interest.

III.

Grant such other and further relief as this Court may deem just and equitable.

Respectfully submitted,

/s/ R.A. Levan
Richard A. Levan, Bar #11477
Michael J. Newman
Deborah E. Siegel

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DATED: SEPTEMBER 19, 1995

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 95-5816

UNITED STATES OF AMERICA, PLAINTIFF-APPELLEE

v.

CHARLES ZANDFORD, DEFENDANT-APPELLANT

[Argued: Jan. 30, 1997]
[Decided: Apr. 3, 1997]

Before: RUSSELL and WILKINS, Circuit Judges, and HERLONG, United States District Judge for the District of South Carolina, sitting by designation.

OPINION

PER CURIAM:

Zandford appeals his conviction and sentence of 52 months imprisonment for committing thirteen counts of wire fraud. Zandford contends the Government failed to present sufficient evidence of wire fraud to sustain his convictions; and that the district court erred in admitting the testimony of four Government witnesses. Because each of Zandford's grounds for appeal is meritless, we affirm.

I.

Charles Zandford worked as a stockbroker for a brokerage firm. which had offices in Bethesda, Maryland, and New York, New York, from May 1987 through February 1991. He met William Wood in November 1987, and solicited Wood to invest with him. Wood, 71 years old at the time, opened a joint investment account with Zandford. The account was titled in Wood's name and that of his daughter, Diane Okstulski, who suffered from a multiple personalities disorder. Within four months after their first meeting, Zandford persuaded Wood to entrust him with $419,255 to "conservatively invest." Nineteen months later, all of Wood's money was gone.

In January 1991, the National Association of Security Dealers ("NASD") inadvertently discovered that Zandford had systematically transferred money on over twenty-six separate occasions from Wood's and Diane's investment account to accounts either controlled by Zandford or in Zandford's name. When confronted about the transfers one month later, Zandford acknowledged that Wood and Okstulski (hereinafter "the Woods") had transferred money to him. He explained that pursuant to three agreements he had entered into with the Woods in 1988 and 1989, they gave him: $100,000 under a personal services agreement for services he rendered to them as an overseer of their personal and medical needs; $150,000 to invest in and operate a vintage car restoration business; and $140,000 as an unsecured personal loan for reasons undisclosed. The remaining money he allegedly spent on behalf of the Woods. Mr. Wood died in 1991.

In April 1995, a federal grand jury issued a superseding indictment against Zandford for thirteen counts of wire fraud in violation of 18 U.S.C. § 1343. The first count related to money Zandford obtained from selling the Woods' shares in a mutual fund. The remaining counts related to twelve separate withdrawals Zandford made from the Woods' joint investment account. After a three-week trial, a jury convicted Zandford on all counts. He received a sentence of 52 months imprisonment.

II.

Zandford contends that the evidence is insufficient to support his wire fraud convictions. When reviewing challenges to sufficiency of the evidence, we determine whether any rational trier of fact could have found the essential elements of the charged offenses beyond a reasonable doubt.[1] Assuming the jury weighed the evidence, resolved all conflicts in the testimony, and drew all reasonable inferences from the facts, we consider all of the evidence in the light most favorable to the government.[2]

To prove Zandford violated the wire fraud statute, the Government had to establish: (1) the existence of a scheme to defraud and (2) use of interstate wire communications to facilitate the scheme.[3]

First, Zandford contends there was insufficient evidence to find that he had engaged in a scheme to

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1 *Jackson* v. *Virginia*, 443 U.S. 307, 319 (1979).

2 *Id.*

3 18 U.S.C.A. § 1343 (West Supp. 1997): *United States* v. *ReBrook*, 58 F.3d 961, 966 (4th Cir. 1995) (citation omitted).

defraud. He claims the Woods willfully transferred their money to him via three lawfully-executed agreements. He also maintains that the Government's case against him was flawed because it failed to use relevant contract law to invalidate the agreements. The Government's burden, however, was not to disprove Zandford's defense. Rather the Government's obligation was to place enough evidence before the jury to prove beyond a reasonable doubt that Zandford engaged in a scheme to defraud the Woods.

The term "scheme to defraud" means "any scheme to deprive another of money or property by means of false or fraudulent pretenses, representations or promises."[4] It includes fraudulent schemes based on false statements or factual misrepresentations.[5] Thus, with respect to the alleged agreements, it was sufficient for the Government to cast doubt upon the validity of the agreements or demonstrate that the agreements themselves manifested the scheme by which Zandford tried to "legitimize" the wholesale theft of the Woods' money.

The Government presented ample direct and circumstantial evidence showing that Zandford had engaged in a scheme to defraud the Woods. It showed that: (1) Zandford had systematically transferred large sums of money from the Woods' account to his own accounts over a nineteen month period; (2) prior to November 1987, the Woods had no relationship with Zandford; (3) Zandford, and not the Woods, benefitted from the money transfers; (4) the Woods were vulnerable victims due to their physical and mental limitations; (5) the personal services agreement, the loan, and the vintage

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[4] *Carpenter* v. *United States*, 184 U.S. 19, 27 (1987).

[5] *See, McNally* v. *United States*, 483 U.S. 350, 359 (1987).

car restoration business were not only contrary to the Woods' stated investment objectives, but they violated the rules of NASD and those of Zandford's employer that prohibited brokers from engaging in such arrangements; and (6) vehicles owned as part of the vintage car restoration business were titled in the name of Zandford's girlfriend as opposed to the Woods' names. Additional evidence showing a scheme to defraud included Zandford's failure to disclose to his employer the existence of the agreements and personal loans; his failure to report on his taxes or bank loan applications that he received income from acting as the personal representative; and his failure to disclose on his taxes his involvement in a vintage car restoration business. Zandford's contention that there is insufficient evidence supporting that he had engaged in a scheme to defraud the Woods is meritless.

Zandford also contends that there was insufficient evidence to find that he used wire transfers in furtherance of a scheme to defraud. This contention is also without merit. On behalf of the Government, the branch manager and the compliance officer of the brokerage firm testified that every time money was withdrawn from the Woods' account a wire communication was used between the branch office in Bethesda, Maryland, where Zandford worked, and New York New York, to verify the availability of funds and permit the transfer. Additionally, computer-monitored money line documents showed that Zandford used a wire communication between Maryland and New York for nine of the thirteen withdrawals he made from the Woods' joint account.

Given the foregoing evidence, we hold that any rational trier of fact could have found the essential ele-

ments of wire fraud beyond a reasonable doubt. We affirm Zandford's thirteen convictions for wire fraud.

III.

Next, Zandford contends the district court erred in admitting the testimony of four government witnesses. We review evidentiary rulings for abuse of discretion.[6]

First, Zandford contends that the Government used the hearsay testimony of two doctors and a nurse in order to establish Mr. Wood's incompetence during the time period in which Zandford entered into the agreements with the Woods. The record reveals both doctors testified as expert witnesses and treating physicians. A neurologist testified that Mr. Wood was his patient during 1988-91 and was virtually blind, completely incompetent, and medically disabled. The other doctor, a general physician, corroborated much of the neurologist's testimony, and stated that from January 1989 to February 1990, Mr. Wood suffered from dementia. The doctors' proffered testimony as to Mr. Wood's medical condition during the relevant time period was admissible under Federal Rule of Evidence 703, "Bases of Opinion Testimony by Experts," and under a hearsay exception, Federal Rule of Evidence 803(4), "Statements for purposes of medical diagnosis or treatment."

Zandford also contends that the district court erred in allowing the Government to admit into evidence the nursing notes of the nurse assigned to care for Mr. Wood in a nursing home from January 1990 to June 1991. The notes characterized Mr. Wood's medical con-

[6] *United States* v. *Heater*, 63 F.3d 311, 320 (4th Cir. 1995).

dition as "senile dementia," and the nurse testified that her observations of Mr. Wood were consistent with that characterization. Pursuant to Federal Rule of Evidence 803(6), "Records of regularly conducted activity," these notes were properly admitted as they were kept in the regular course of business by the nursing staff at the nursing home.

Second, Zandford contends that the district court erred in allowing a psychologist to testify regarding Okstulski's mental capacity during the relevant time period. This testimony was also properly admitted under Federal Rules of Evidence 703 and 803(4) as discussed above.

The district court did not abuse its discretion in admitting the testimony of the doctors, the psychologist, or the nurse's notes.[7]

IV.

For the foregoing reasons Zandford's conviction and sentence for thirteen counts of wire fraud is

AFFIRMED.

[7] Zandford raises numerous other issues which we hold to be meritless.

APPENDIX E

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

CRIMINAL NO. WN-94-0165
(Wire Fraud, 18 U.S.C. § 1343)

UNITED STATES OF AMERICA

v.

CHARLES ZANDFORD

[Filed: Apr. 6, 1995]

SUPERSEDING INDICTMENT

The Grand Jury for the District of Maryland charges that:

1. At all times pertinent to this Indictment:

(a) Dominick & Dominick (hereinafter "Dominick") was a securities broker/dealer located at 90 Broad Street, New York, New York and maintained a branch office located at 7200 Wisconsin Avenue, Suite 710, Bethesda, Maryland; and

(b) CHARLES ZANDFORD was a general securities broker/representative employed by Dominick & Dominick in its Bethesda, Maryland branch office.

The Scheme and Artifice to Defraud

2. Beginning in or about November of 1987 and continuing, thereafter, to in or about September of 1990 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, did devise and intend to devise a scheme and artifice to defraud and to obtain money and property from William R. Wood and Diane Wood Okstulski by means of false and fraudulent pretenses, representations, and promises.

3. It was a part of the said scheme and artifice to defraud that in November of 1987, CHARLES ZANDFORD agreed to become the securities broker/representative for William R. Wood and his daughter Diane Wood Okstulski. Pursuant to this agreement, in November of 1987, William R. Wood and Diane Wood Okstulski opened a joint investment account at Dominick & Dominick in Bethesda, Maryland.

4. It was a further part of the said scheme and artifice to defraud that between the period of November of 1987 and March of 1988, William R. Wood and Diane Wood Okstulski, entrusted CHARLES ZANDFORD with $419,255 to be held in the joint investment account at Dominick & Dominick. By September 28, 1990, CHARLES ZANDFORD caused the balance in the joint investment account to be depleted.

5. It was a further part of the said scheme and artifice to defraud that CHARLES ZANDFORD caused checks to be issued against the security positions of William R. Wood and Diane Okstulski and made payable to CHARLES ZANDFORD, thereby causing their securities to be liquidated. During the period of March of 1988 through September of 1990, CHARLES ZANDFORD caused checks in the amount of $346,292.78 to be issued from the joint investment account of William R. Wood and Diane Okstulski. CHARLES ZANDFORD then made personal uses of this money to,

among other things, pay credit cards, personal loans and purchase automobiles.

6. It was a further part of the said scheme and artifice to defraud that CHARLES ZANDFORD sold securities in William R. Wood and Diane Wood Okstulski's joint investment account, deposited a check made payable to William Wood from the Department of Labor, Office of Workmen's Compensation into the joint investment account and then made personal use of the money.

Executing The Scheme

7. On or about March 8, 1988 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice to defraud, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York in connection with the purchase of mutual fund shares in Colonel Tax-Exempt Insured Mutual Fund on behalf of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT II

The Grand Jury for the District of Maryland further charges that:

1. The allegations contained in Paragraphs 1 through 6 of Count I are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about August 4, 1988, in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York, in connection with the withdraw of $145,000.00 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT III

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs 1 through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about July 18, 1989 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York in connection with the withdraw of $13,156.70 from the joint invest-

ment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT IV

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs 1 through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about August 14, 1989 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York in connection with the withdraw of $15,000.00 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT V

The Grand Jury for the District of Maryland further charges that:

1. The allegations contained in Paragraphs 1 through 6 of Count I are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about September 15, 1989 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York in connection with the withdraw of $20,012.19 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT VI

The Grand Jury for the District of Maryland further charges that:

1. The allegations contained in Paragraphs 1 through 6 of Count I are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about November 24, 1989 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York in connection with the withdraw of $20,016.28 from the

joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT VII

The Grand Jury for the District of Maryland further charges that:

1. The allegations contained in Paragraphs 1 through 6 of Count I are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about December 28, 1989 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York in connection with the withdraw of $5,012.66 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT VIII

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs 1 through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about January 19, 1990 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication, signs, signals and sounds, that is, a wire transfer communication between Maryland and New York in connection with the withdraw of $5,000.00 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT IX

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs l through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about January 25, 1990 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication between Maryland and New York in connection with the withdraw of $15,000.00 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT X

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs 1 through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about February 13, 1990 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication between Maryland and New York in connection with the withdraw of $28,782.72 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT XI

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs 1 through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about March 5, 1990 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication between Maryland and New York in connection with the withdraw of $19,171.21 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT XII

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs 1 through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about April 23, 1990 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication between Maryland and New York in connection with the withdraw of $8,134.50 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U.S.C. § 1343

COUNT XIII

And the Grand Jury for the District of Maryland further charges:

1. The allegations contained in Paragraphs 1 through 6 of Count One are realleged and incorporated herein as though fully set out in this Count of the Superseding Indictment.

2. On or about September 6, 1990 in the State and District of Maryland,

CHARLES ZANDFORD

the defendant herein, for the purpose of executing and attempting to execute the aforesaid scheme and artifice, did knowingly cause to be transmitted in interstate commerce by means of a wire communication between Maryland and New York in connection with the withdraw of $2,864.13 from the joint investment account of William R. Wood and Diane Wood Okstulski.

18 U. S. C. § 1343

/s/ LYNNE A. BATTAGLIA
LYNNE A. BATTAGLIA
UNITED STATES ATTORNEY

[Illegible]
FOREPERSON

April 6, 1995
DATE

APPENDIX F

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 99-1733
CA-95-2826-AMD

SECURITIES & EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

CHARLES ZANDFORD, DEFENDANT-APPELLANT

[Filed: Mar. 26, 2001]

On Petition for Rehearing and Rehearing En Banc

The appellee's petition for rehearing and rehearing en banc was submitted to this Court. As no member of this Court or the panel requested a poll on the petition for rehearing en banc, and

As the panel considered the petition for rehearing and is of the opinion that it should be denied,

IT IS ORDERED that the petition for rehearing and rehearing en banc is denied.

For the Court,

/s/ Patricia S. Connor
CLERK

APPENDIX G

STATUTORY APPENDIX

1. Section 78j of Title 15 of the United States Code provides in relevant part:

Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. Section 240.10b-5 of Title 17 of the Code of Federal Regulations provides:

Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to

make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

(2)

No. 01-147

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 2001

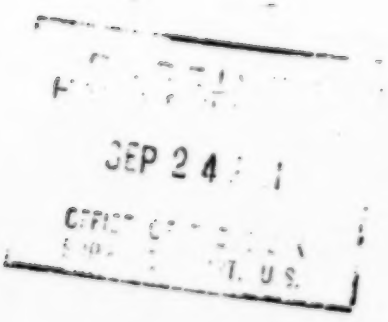
SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES ZANDFORD,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION



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*** Counsel of Record**

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QUESTIONS PRESENTED

1. Whether the petition for certiorari properly asks this Court to consider the adequacy of the SEC's civil complaint to state a cause of action for securities fraud when that issue was neither raised below by the SEC nor considered by the court of appeals.

2. Whether the court of appeals correctly concluded that proof that a stock broker converted funds from a discretionary securities investment account does not, without more, establish fraud "in connection with" a sale of securities within the meaning of Section 10(b) of the Securities Act of 1934 or Rule 10b-5 of the Securities and Exchange Commission.

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No. 01-147

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 2001

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,
v.

CHARLES ZANDFORD,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

STATEMENT

Because respondent Charles Zandford questions whether the petition for certiorari presents an issue that was preserved for review, this statement will describe with some specificity what the Securities and Exchange Commission ("SEC") pressed and what the court of appeals passed upon below. The SEC sought summary judgment in this civil securities fraud action it brought against Charles Zandford. It contended below that under the doctrine of collateral estoppel, Zandford's prior criminal conviction for wire fraud precluded any defense to the civil

action it had brought against him. Pet. App. 3a, 16a-17a.[1] The district court agreed and granted summary judgment in favor of the SEC. Pet. App. 17a-18a. The court of appeals concluded, however, that the facts established from the criminal case did not establish securities fraud. On that basis, it reversed the district court and also directed that the case be dismissed. Pet. App. 4a-5a, 14a. The SEC does not ask this Court to review the summary judgment ruling. Rather, the SEC now asks this Court to grant review and to decide for the first time in this case whether the facts asserted in the civil complaint, including significant assertions, which were neither established for purposes of summary judgment nor considered by the court of appeals, establish securities fraud.

The Wire Fraud Conviction

In April of 1995, a federal grand jury returned a superseding indictment, charging Zandford with thirteen counts of wire fraud. Pet. App. 40a. The superseding indictment alleged that Zandford, a securities broker and representative, had engaged in a scheme to defraud William Wood ("Wood"), and his daughter Diane Wood Okstulski ("Okstulski") (collectively "the Woods"), two customers who had opened an investment account through Zandford in November of 1987 at the Maryland offices of Dominick & Dominick ("Dominick"), "a securities broker/dealer." Pet. App. 40a-41a ¶¶ 1-3.

In outlining the scheme to defraud, the superseding indictment alleged that between November of 1987 and March of 1988, the Woods entrusted Zandford with a total of $419,225 to

[1] "Pet. App." refers to the appendix filed with the petition for certiorari. "Opp. App." refers to the appendix filed with the brief in opposition.

be held in their investment account, and that Zandford depleted the money by September 28, 1990. Pet. App. 41a at ¶ 4. The indictment specifically alleged that between March of 1988 and September of 1990, Zandford caused checks in the amount of $346,292.78 to be issued from the investment account. Pet. App. 41a-42a at ¶ 5. These checks were allegedly issued "against the security positions" of the Woods, causing their securities to be "liquidated." Pet. App. 41a at ¶ 5. According to the superseding indictment, Zandford then made personal use of that money. Pet. App. 41a-42a at ¶ 5. Additionally, the superseding indictment alleged that Zandford "sold securities in William R. Wood and Diane Wood Okstulski's joint investment account, deposited a check made payable to William Wood from the Department of Labor, Office of Workmen's Compensation into the joint investment account and then made personal use of the money." Pet. App. 42a at ¶ 6.

Each of the thirteen counts of the superseding indictment charged Zandford with causing a wire transfer to be made between Maryland and New York in execution of the scheme to defraud. Count One alleged that a wire transfer communication was made "in connection with the purchase of mutual fund shares" on behalf of the Woods in March of 1988.[2] Pet. App. 42a at ¶ 7. Counts Two through Thirteen charged Zandford with causing wire communications to be made "in connection with" the withdrawal of funds from the Woods' investment account over a two-year period, from August of 1988 to September of 1990. Pet. App. 40a-50a.

Zandford was convicted on all counts, sentenced to 52 months in prison, and ordered to pay $10,800 in restitution. Pet. App. 2a. On appeal, he argued, inter alia, that there was

[2] The court of appeals mistakenly referred to this count as involving a sale of shares in a mutual fund. Pet. App. 2a, 35a.

insufficient evidence of a scheme to defraud because the Woods had willfully transferred their money to him via three lawfully-executed agreements. Pet. App. 35a. The court of appeals rejected Zandford's argument without making any reference to securities. In determining that there was insufficient evidence to sustain the conviction, the court of appeals pointed to various factors in determining that there was sufficient evidence to sustain the conviction, including the Woods' mental and physical limitations, the transfer of large sums of money from the investment account to Zandford's own accounts, and the fact that the agreements underlying Zandford's defense were contrary to the Woods' conservative investment objectives. Pet. App. 36a-38a.

The SEC's Civil Complaint

In September of 1995, the SEC filed the civil complaint in this action, under Section 17(a) of the Securities Act of 1933, 17 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. Pet. App. 25a. The complaint alleged that Zandford "misappropriated" $343,000 of the Woods' funds and that he excessively traded securities from their investment account. Pet. App. 27a at ¶ 10. According to the complaint, Wood, who suffered from various physical and mental disabilities, opened the investment account on behalf of himself and his mentally disabled daughter Okstulski, with "safety of principle and income" as his objective. Pet. App. 27a-28a at ¶¶ 9, 11, 13. The complaint alleged that Wood made an initial deposit of $130,000 in September of 1987 and gave Zandford an additional $289,000 in March of 1988. Pet. App. 27a-28a at ¶¶ 11, 12. Additionally, the complaint alleged that Wood held unspecified mutual fund shares outside the investment account. Pet. App. 27a at ¶ 10.

As to the misappropriation claim, the complaint alleged that Zandford's fraudulent scheme began in May of 1988, shortly after Wood was hospitalized with a stroke. Pet. App. 28a at ¶ 16. Between May and June of 1988, Zandford issued three checks to himself totaling $41,000 that were allegedly drawn on the Woods' mutual fund account, after mutual fund shares in the account were sold. Pet. App. 28a at ¶ 16. Zandford obtained an additional $145,000 in July of 1998 by selling securities in the investment account and then obtaining a check from Dominick that he deposited into a bank account under his control. Pet. App. 29a at ¶ 17. The complaint further alleged that between July of 1988 and June of 1990, Zandford sold securities held in the investment account as well as mutual fund shares held elsewhere. Pet. App. 29a at ¶ 18. After the resulting proceeds were deposited into the Woods' investment account, Zandford caused checks totaling $157,000 to be issued from that account and deposited them into his own accounts. Pet. App. 29a at ¶ 18. Finally, the complaint alleged that Zandford engaged in excessive trading, or "churning." Pet. App. 30a at ¶¶ 20-23.

The SEC's Motion for Partial Summary Judgment

In April of 1998, the SEC moved for partial summary judgment based exclusively on a collateral estoppel theory. Pet. App. 3a, 16a-17a. It asserted that the facts established in the superseding indictment also established civil securities fraud and that Zandford was estopped from contesting those facts. Opp. App. 15a-16a. The SEC supported the motion with selected portions of the record from the criminal case, including in pertinent part: the superseding indictment, jury charge, verdict form, criminal judgment, and the unpublished opinion of the court of appeals affirming the conviction. Opp. App. 16a-17a.

Zandford moved to conduct limited discovery. Pet. App. 3a. The SEC opposed Zandford's discovery request, claiming that such discovery was irrelevant to answer the motion for partial summary judgment because "[t]he Commission's motion for partial summary judgement [sic] is based exclusively on the application of the doctrine of collateral estoppel." Opp. App. 11a (emphasis added).

The District Court Decision and the Appeal

On March 2, 1999, the district court granted the SEC's motion for partial summary judgment, enjoined Zandford from committing future violations of the securities laws, and awarded disgorgement in the amount of $343,000, without prejudgment interest, less a credit of $10,800 for the prior restitution award.[3] Pet. App. 17a-18a, 21a-24a. The district court found that "Zandford's criminal conviction was based on the same facts alleged by the Commission against Zandford . . . and that Zandford is therefore collaterally estopped from relitigating the facts underlying his conviction." Pet. App. 22a. The district court granted summary judgment because it found that the prior criminal conviction established all elements of the SEC's misappropriation claim. Pet. App. 16a-17a, 22a. Zandford appealed.

[3] The SEC had reserved from the motion for partial summary judgment the claims of excessive trading, or "churning," which it acknowledged were not addressed by the criminal conviction and thus could not be resolved by invoking collateral estoppel. Opp. App. 16a, n.1. The SEC later made clear to the court of appeals that because it was "unlikely to receive any further relief by pursuing its excessive trading claims, the Commission has no intention of taking any further action against Zandford. Consequently, the Commission did not question the district court's decision to enter final judgment even though the Commission moved for partial summary judgment." Opp. App. 9a n.2.

In an opinion written by Chief Judge Wilkinson, and joined by Judges Michael and Traxler, the court of appeals reversed the district court, determining that Zandford was not estopped from defending the motion for summary judgment. Pet. App. 1a. The court of appeals applied this Court's decision in Emich Motors Corp. v. General Motors Corp., 340 U.S. 558 (1951), which holds that collateral estoppel operates to foreclose the relitigation of any legal issues or facts in a subsequent civil proceeding that were previously "put in issue and directly determined" in a prior criminal conviction. Id. at 569 (internal quotation marks and citations omitted); Pet. App. 4a. The court of appeals then held that collateral estoppel did not bar relitigation of any issue of law because the conviction for wire fraud did not require a determination of whether Zandford's "fraud was sufficiently connected to a securities transaction."[4] Pet. App. 5a.

The court of appeals also considered the SEC's arguments that collateral estoppel barred relitigation of the fact that "Zandford sold securities as part of a scheme to misappropriate proceeds," and that the district court properly found that such a scheme satisfies the "in connection with" requirement as a matter of law. Pet. App. 5a. The court of appeals accepted the SEC's contention that "the criminal trial established the fact that Zandford sold securities as part of a scheme to misappropriate proceeds."[5] Pet. App. 5a. It concluded, however, that "[t]he

[4] The court added that "[s]ince Zandford was never charged with a criminal violation of § 10(b), he did not have the opportunity to argue at trial or on appeal that, as a legal matter, his fraud was not sufficiently connected to a securities transaction." Pet. App. 5a.

[5] The court of appeals did not address Zandford's argument below that for purposes of collateral estoppel, the SEC did not establish any of the facts relating to securities that were discussed in the superseding indictment because they were not directly determined in the wire fraud case.

record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion." Pet. App. 9a. The court of appeals also noted that the SEC did not dispute in its brief or at oral argument that this was a discretionary brokerage account and that Zandford "could trade securities without first having to gain the Woods' approval." Pet. App. 10a.

Within this context, the court of appeals held that the "only connection with federal securities laws is that the funds were converted from a securities investment account." Pet. App. 14a (internal quotation marks and citation omitted). The court of appeals also held that the "'intent to cause a conversion . . . at some uncertain future time and through uncertain means does not bring federal law into play, even though that intent is held at the time a purchase or sale of securities occurs.'" Pet. App. 10a (quoting Pross v. Katz, 784 F.2d 455, 459 (2d Cir. 1986)). Accordingly, the court of appeals concluded that the SEC was not entitled to summary judgment because it had not established, through the criminal trial papers it relied upon, that fraud was committed in connection with a securities transaction, even though the proceeds were converted to Zandford's use thereafter. Pet. App. 8a-14a. The court of appeals also directed that the case be dismissed on remand. Pet. App. 14a.

The SEC sought rehearing and rehearing en banc. It asked the court of appeals to reinstate the district court decision granting summary judgment to the SEC. Opp. App. 4a, 7a. The SEC neither questioned the court's order that the case be dismissed on remand nor asked the court to consider the adequacy of the civil complaint to state a cause of action. Opp. App. 4a, 7a. The court of appeals denied the petition for rehearing and rehearing en banc. Pet. App. 51a.

REASONS FOR DENYING THE PETITION

I. THE ISSUE PRESENTED FOR REVIEW WAS NEITHER PRESSED BY THE SEC BELOW NOR PASSED UPON BY THE COURT OF APPEALS.

The petition for certiorari asks this Court to grant review and to consider whether the order remanding the case with instructions to dismiss the action against Zandford was in error because the SEC's civil complaint states an actionable claim of securities fraud under § 10(b). Pet. 7, n.2. The SEC, however, did not question the order to dismiss the case when it sought rehearing. Opp. App. 4a, 7a. Further, the SEC never asked the court of appeals to consider, and the court of appeals never decided, the sufficiency of the complaint to state a cause of action. Rather, the court of appeals used the more limited set of facts stated in the superseding indictment to evaluate the securities fraud claim. Pet. App. 2a, 5a, 14a. Therefore, this Court should deny the petition because the SEC is asking this Court to decide an issue that was neither raised nor considered below. See, e.g., Taylor v. Freeland & Kronz, 503 U.S. 638, 646 (1992) ("[T]his Court does not decide questions not raised or resolved in the lower court[s].") (internal quotation marks and citation omitted); Delta Air Lines, Inc. v. August, 450 U.S. 346, 362 (1981) ("Although defendant's petition for certiorari presented the question of the District Judge's abuse of discretion in denying defendants costs under Rule 54(d), that question was not raised in the Court of Appeals and is not properly before us.").

In a short footnote, the SEC justifies this attempt to recast the case as follows:

> Because the court of appeals, rather than merely reversing the district court's grant of summary judgment, dismissed the Commission's complaint for failure to state a claim, this Court must assume that the allegations in the complaint are true and could affirm the dismissal only if the Commission could prove no set of facts that would entitle it to relief. See Hartford Fire Ins. Co. v. California, 509 U.S. 764, 811 (1993).

Pet. 7, n.2. The proffered justification is inadequate. The SEC's authority for this assumption, Hartford Fire, merely states the standard that applies when a court is considering a motion to dismiss a complaint. 509 U.S. at 811. That fundamental proposition is not relevant here because the court of appeals did not rule on a motion to dismiss the complaint. In fact, there is no indication in its opinion that the court of appeals ever reviewed the complaint.

Rather, the decision by the court of appeals to dismiss the case, in effect granting summary judgment to the non-moving party, is an unusual, but not unrecognized action by an appellate court.[6] See 10A Charles Alan Wright, Arthur R. Miller & Mary Kay Kane, Federal Practice and Procedure § 2720 (3d ed. 1998) ("Wright & Miller") ("[I]f the facts were fully developed at the summary-judgment hearing so that the court of appeals can determine that the nonmoving party clearly was entitled to a judgment as a matter of law, an entry of judgment for

[6] The opinion does not explain the reason for dismissing the case, and the SEC did not raise the issue when it sought rehearing. The court of appeals may well have concluded that the SEC had fully developed the facts based upon something that was said at oral argument. It may also have reached that conclusion because the SEC claimed in its memorandum accompanying the motion for summary judgment that the facts described in the superseding indictment mirrored the facts stated in the complaint, suggesting that the SEC had no additional evidence it wished to present. Opp. App. 15a-16a ("The facts underlying Zandford's criminal case are identical to those alleged under the Commission's general factual allegations and, more specifically, the misappropriation allegations of the instant complaint."). Regardless, the SEC could have eliminated the confusion if it had brought the issue to the attention of the court of appeals.

the nonmoving party may be proper if there is no procedural prejudice to the moving party."); see, e.g., Dickeson v. Quarberg, 844 F.2d 1435, 1444 n.8 (10th Cir. 1988) (granting partial summary judgment to non-moving parties because "issue[s] were fully explored"); Procter & Gamble Indep. Union v. Procter & Gamble Mfg. Co, 312 F.2d 181, 190 (2d Cir. 1962) ("Since we hold that there was no triable issue of fact, and that defendant, although it made no cross motion, was entitled to summary judgment, summary judgment will be entered for defendant."), cert. denied 374 U.S. 830 (1963).

Thus, if the SEC considered the order dismissing the case outright to be procedurally prejudicial, it could have filed a petition for rehearing, asking the court of appeals to modify its order. The SEC did in fact seek rehearing and rehearing en banc, but did not ask the Court to reconsider the remand order. Opp. App. 4a (stating that "[t]he issue on which the Commission [sought] rehearing [was] whether the defendant's failure to tell his customer that he intended to convert the proceeds of each of the securities sales was 'in connection with' those sales"). Moreover, the SEC has neither asked this Court to consider the authority of the court of appeals to order summary judgment in favor of a non-moving party,[7] nor has it raised an objection to the procedural fairness of dismissing the action rather than remanding for further proceedings.[8] See

[7] The SEC should have raised this issue as a question presented for review. See Izumi Seimitsu Kogyo Kabushiki Kaisha v. U.S. Philips Corp, 510 U.S. 27, 30-31 (1993) (dismissing certiorari as improvidently granted where petitioner failed to raise a threshold standing issue as a question presented for review, in addition to the question upon which certiorari was granted).

[8] This Court has had occasion to grant certiorari and reverse a court of appeals' decision to dismiss a case for reasons that had not been considered by the district court, where the ruling was procedurally unfair. See Fountain v. Filson, 336 U.S. 681, 682-83 (1949) (per curiam) (granting certiorari and reversing when the court of appeals, after deciding that summary judgment had been erroneously granted by the district court,

Helis v. Ward, 308 U.S. 365, 369-370 (1939) (refusing to consider the court of appeals' failure to remand for a new trial, where the issue was neither raised in a petition for rehearing in the court of appeals nor as a ground upon which the petition for certiorari was predicated).

II. THE PETITION'S RELIANCE ON FACTS NOT CONSIDERED BY THE COURT OF APPEALS MIRES THIS CASE IN FACTUAL ISSUES THAT ARE NOT WORTHY OF REVIEW BY THIS COURT.

The petition for certiorari ignores that the SEC could not rely on the allegations in the civil complaint, particularly those related to the mutual fund account, once it elected to pursue summary judgment on the basis of collateral estoppel. See 10A Wright & Miller § 2721 n.8 (citing cases holding that when considering a motion for summary judgment, the court cannot consider allegations contained in the pleadings, but rather must make its legal conclusions from facts shown to exist through the evidence submitted with the motion for summary judgment) (citations omitted). The SEC's motion for partial summary judgment and supporting memorandum of law state that because "the jury [in the wire fraud case had] already spoken regarding Zandford's liability," he was collaterally estopped from relitigating these claims and that the SEC was entitled to summary judgment on the civil fraud claims. Opp. App. 16a. Further, the SEC opposed Zandford's discovery request, claiming that such discovery was irrelevant to answer the motion for partial summary judgment because "[t]he Commission's motion for partial summary judgement [sic] is based exclusively on the application of the doctrine of collateral estoppel." Opp. App. 11a (emphasis added).

For purposes of summary judgment, the SEC substantially narrowed the factual basis for its case.[9] The primary evidence the SEC relied upon was the superseding indictment in the wire fraud case. The superseding indictment refers to only one investment account and contains general allegations of securities being sold or liquidated.[10] Pet. App. 41a-42a. The SEC did not, however, establish the identity of any securities that were sold. Therefore, the court of appeals, focusing on the only account before it, the brokerage account, noted that the SEC never contested that this was a discretionary account, which meant that Zandford could trade without consulting with his clients.[11] Pet App. 9a -10a. This factor was important to the decision of the court of appeals because it helped lead to the conclusion that the sales were conducted in a "routine and customary fashion."[12] Pet. App. 9a.

Although it could have sought certiorari and asked this Court to review the issue decided below, whether the facts that were established by the wire fraud conviction also established securities fraud, the SEC has not taken that position. Instead, it now attacks the reasoning of the

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exceeded its authority and ordered that summary judgment be entered on a different theory that had not been presented to the district court). That situation, however, is not presented here because the SEC has not raised it.

[9] The SEC recognized that the churning claim asserted in the complaint was not addressed in the criminal case and expressly noted that it was not moving for summary judgment on that claim. Opp. App. 16a, n.1.

[10] The jury charge, verdict form, criminal judgment, and opinion on appeal do not add significantly to the evidence established by the superseding indictment, and the petition does not rely on them in any material way.

[11] The petition for certiorari acknowledges that the Woods entrusted Zandford with $419, 255 to invest "in his discretion." Pet. 2.

[12] Because it was a discretionary account, Zandford had sole authority to make investment decisions. See, e.g., Bowley v. Stotler, 751 F.2d 641, 644 (3d Cir. 1985).

court of appeals on the basis of the facts asserted in the complaint.[13] The civil complaint contains several allegations regarding a mutual fund account that are not mentioned in the summary judgment papers or in the opinions below. The complaint states that Zandford misappropriated $343,000 from both the investment account and a mutual fund account. Pet. App. 27a at ¶ 10. It also alleges that between May and June of 1988, Zandford issued three checks to himself totaling $41,000, which were allegedly drawn on the Woods' mutual fund account from funds obtained through the sale of mutual fund shares, Pet. App. 28a at ¶ 16. The complaint further alleges that between July of 1989 and June of 1990, Zandford obtained approximately $111,000 by liquidating shares in the mutual fund account on ten occasions.[14] Pet. App. 29a at ¶ 18.

These allegations present details of a fraudulent scheme relating to a mutual fund account that were never analyzed by the court of appeals, but are incorporated in the petition for certiorari and relied upon by the SEC to establish why this case is worthy of review. The difference is critical because the court of appeals rested its decision in part on the SEC's failure to dispute

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[13] See, e.g., Pet. 3-4 (stating that the complaint alleged that Zandford "without the Woods' knowledge or consent . . . issued checks to himself drawn on the Woods' joint mutual fund account, and that the funds to pay the checks were obtained through the sale of mutual fund shares," that Zandford "sold mutual fund shares or other securities owned by the Woods without their knowledge or consent and misappropriated the proceeds," and that Zandford "thereby violated section 10(b) and Rule 10b-5") (citing Pet. App. 28a-31a); Pet. 7-8, 9, 16 (additional references to mutual fund shares).

[14] Similarly, the complaint references specific stock transactions, specific dollar amounts, and specific actions Zandford took with the money, but these specifics are not found in the superseding indictment. The complaint alleges that Zandford sold three securities in the Wood/Okstulski investment account for a total of $145,000 and that Zandford obtained a check in the amount of the proceeds, which he deposited in a bank account under his control. Pet. App. 29a at ¶ 17. The complaint also alleges that Zandford sold $46,000 worth of securities in the investment account and then caused checks in that amount to be issued to Woods/Okstulski, which he then deposited in accounts in his name or under his control. Pet. App. 29a at ¶ 18.

Zandford's claim that the brokerage account was a discretionary account and that the bare reference to sales of securities did not establish fraud because he was authorized to trade securities without obtaining prior approval. Pet. App. 9a-10a. The petition, by including the mutual fund account in its analysis, never directly confronts the fact that the decision of the court of appeals is limited to a discretionary brokerage account.

It is impossible at this point to determine how this case would have been litigated or decided below if anything other than the discretionary brokerage account were in issue. By injecting the mutual fund account into the analysis at this point, the SEC has mired this case in factual issues that are not worthy of this Court's consideration, even if the case might otherwise present securities fraud issues that would be worthy of review.

III. THIS CASE IS NOT WORTHY OF REVIEW BECAUSE THRESHOLD ISSUES REGARDING COLLATERAL ESTOPPEL MAY PREVENT THIS COURT FROM REACHING ANY QUESTION REGARDING THE PROPER APPLICATION OF § 10(b) AND RULE 10b-5 WHEN A BROKER CONVERTS A CLIENT'S ASSETS.

Even if this Court determines that the issues presented are worthy of review, this case is not a suitable vehicle to consider the proper application of § 10(b) and Rule 10b-5. As a threshold matter, this Court would need to determine which of at least three different sets of facts should be considered to decide the case. Sorting through this collateral estoppel thicket that the SEC has created is not an appropriate use of this Court's limited resources. The SEC in the petition for certiorari claims that the entire record, including the complaint, should be considered. Pet. 7 n.2. The court of appeals, however, limited its review for purposes of summary judgment

to the facts contained in the superseding indictment. Pet. App. 2a, 5a.

A third alternative, which Zandford raised below and resubmits here, would limit even further the facts that were established for purposes of summary judgment. While Zandford is estopped from contesting those issues of fact and law that were necessarily decided by the jury's verdict, that does not mean that all facts alleged in the superceding indictment should be treated as established facts. See Emich, 340 U.S. at 569 ("In the case of a criminal conviction based on a jury verdict of guilty, issues which were essential to the verdict must be regarded as having been determined by the judgment."). The issue of whether Zandford liquidated securities was not "actually determined" by the jury's verdict because securities sales were not a necessary element of any of the criminal counts of the superseding indictment. Ashe v. Swenson, 397 U.S. 436, 442 (1970) (stating that collateral estoppel "bars relitigation between the same parties of issues actually determined at a previous trial"). The court of appeals affirmed the criminal wire fraud conviction against an insufficiency of evidence claim, without even referring to securities. Pet. App. 35a-38a. Rather, in pertinent part, it described the essential evidence: 1) Zandford had systematically transferred large sums of money from the Woods' account to his own accounts over a nineteen month period; 2) prior to November 1987, the Woods had no relationship with Zandford; and 3) Zandford, and not the Woods, benefitted from the money transfers. Pet. App. 36a. If the Court were to take this case and to determine that Zandford's view is correct, it could not reach the question presented for review because there is no evidence of any securities transactions in the summary judgment record.

IV. THE DECISION OF THE COURT OF APPEALS IS NOT IN CONFLICT WITH ANY DECISION OF THIS COURT.

The SEC portrays the ruling below as a significant departure from this Court's decisions in this area of securities law. Its principle contention is that the ruling cannot be reconciled with United States v. O'Hagan, 521 U.S. 642 (1997), and Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971). The court of appeals, however, fully considered and correctly applied these decisions to the facts before it.[15]

A. United States v. O'Hagan, 521 U.S. 642 (1997).

In O'Hagan, this Court concluded that the undisclosed use of misappropriated insider information to purchase a security constituted securities fraud because the misappropriation of insider information is almost always exploited through securities trading. 521 U.S. at 655-56 (holding that the "in connection with" element was met because "fraud is consummated . . . when, without disclosure to his principal, he uses the information to purchase or sell securities").

Here, the court of appeals found that the SEC did not show this type of critical link. Given the record the SEC placed before it, the court of appeals properly concluded that "[i]t is the SEC's burden to identify a fraudulent act and a particular sale of securities that would satisfy the in connection with requirement. This it has failed to do."[16] Pet. App. 9a. The fraud here

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[15] For purposes of this analysis, Zandford confines the discussion to the facts established in the superseding indictment because those are the facts upon which the court of appeals based its decision.

[16] A case the SEC cites in this context, SEC v. Jakubowski, 150 F.3d 675 (7th Cir. 1998) (Easterbrook, J.), cert. denied, 525 U.S. 1103 (1999), actually supports the court of

was consummated when the money was converted, not when a security was bought or sold.[17] Pet. App. 9a-10a ("Zandford's fraud lay in absconding with the proceeds .... The record contains no suggestion that the sales themselves were conducted in other than a routine and customary fashion.").

The SEC attempts to, but cannot compensate for its failure to properly prove its case, by wrenching O'Hagan from the context in which it was decided and applying it here.[18] O'Hagan does not create an all-purpose ongoing duty to disclose such that any securities transaction occurring between the time the account was set up and when its assets were converted is a § 10(b) violation.[19] Pet. App. 6a. ("The federal securities laws do not cover all types of

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appeals' decision here. The petition cites Jakubowski correctly for its observation that the fraud need not be about the value of a security. Pet. 11. The Seventh Circuit in Jakubowski also noted approvingly that many of its cases "say that a misrepresentation can be 'in connection with' the purchase or sale of securities only if it influences an investment decision." 150 F.3d at 680. There is no securities investment decision in this case that was influenced by fraud, and that is what led the court of appeals to rule as it did.

[17] It is in this context that the court of appeals here expressed concern that the SEC's position, if accepted, would result in § 10(b) subsuming "significant areas of state law." Pet. App. 14a. The court of appeals' references to state law are not inconsistent with any language in O'Hagan, as the petition argues. Pet. 12-13.

[18] In O'Hagan, the SEC limited the sweep of its "in connection with" argument, emphasizing that the misappropriated information could "only" be used in a securities transaction. 521 U.S. at 657-58; Id. at 683-84 (Thomas, J., concurring). In this case, the SEC does not limit the implications of its position. If the SEC's position were accepted, any securities transaction occurring during the course of a fraudulent scheme would constitute securities fraud.

[19] Using non-disclosure of a breach of fiduciary duty as itself being an independent breach of fiduciary duty has been rejected in other contexts. See Kas v. Financial Gen. Bankshares, Inc., 796 F.2d 508, 513 (D.C. Cir. 1986) ("[P]laintiff may not 'bootstrap' a claim of breach of fiduciary duty into a federal securities claim by alleging that directors failed to disclose that breach of fiduciary duty."); Panter v. Marshall Field & Co., 646

fraud.").

B. Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

The SEC erroneously argues that the "decision of the court of appeals conflicts with this Court's decision in Bankers Life." Pet. 13. In Bankers Life, this Court rejected the holding of the Second Circuit court of appeals that the securities fraud laws should be "limited to preserving the integrity of the securities markets." 404 U.S. at 12 (citation omitted). Based on this erroneous view of the law, the court of appeals had decided that there was no fraud "in connection with" a securities transaction, although the corporate seller was induced to sell a security on the mistaken belief that it would receive the proceeds from the sale because the purchaser was not a party to the fraud. 430 F.2d 355, 360 (2d Cir. 1970). This Court, however, made clear that the facts established securities fraud because the sale was induced by fraud and it made no difference that the purchaser was not implicated and the integrity of the market was not affected when the proceeds were misappropriated. 404 U.S. at 10-12. The Court held that § 10(b) "must be read flexibly, not technically and restrictively." Id. at 12.

Unlike the situation presented in Bankers Life, here the SEC did not show that the Woods were fraudulently induced to sell any security. Rather, the evidence established that they were fraudulently induced to place their money in an account that was subsequently looted. Pet. App. 9a-10a. The court of appeals here correctly concluded that Zandford's fraudulent activities were

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F.2d 271, 288 (7th Cir. 1981) (holding that the "disclosure philosophy of the statute [does not obligate] defendants to reveal either their culpability of their activities, or their impure motives for entering the allegedly improper transaction"), cert. denied, 454 U.S. 1092 (1982).

not sufficiently connected to a securities transaction where the evidence established by the SEC based on its collateral estoppel theory only established that funds were converted from a securities account and the actual role of securities in the fraud is not established. Pet App. 8a-14a. There is no conflict with Bankers Life.

V. THERE ARE NO CONFLICTS WITH OTHER COURTS OF APPEALS.

There is no conflict with the 1982 Ninth Circuit decision United States v. Kendrick, 692 F.2d 1262 (1982), cert. denied, 461 U.S. 914 (1983), despite the SEC's claims in the petition. Pet. 15-16. Kendrick is readily distinguishable because it involved securities in non-discretionary margin accounts that a broker used as collateral for loans he obtained on the accounts. 692 F.2d at 1265-66. Here, the court of appeals was careful to note that the SEC never disputed the fact that the brokerage account was discretionary. Pet. App. 10a. Further, the Kendrick court expressly found that the fraud was linked to sales of securities. The court found that the collateral interest in the securities that the fraudulently obtained loans created were sales of interests in those securities. 692 F.2d at 1265. The court rejected an argument that the fraud was not "in connection with" the loans. Id. ("At the time Kendrick caused Dean Witter to issue the checks . . . he was engaged in fraud."). Unlike the situation posed in Kendrick, the court of appeals in this case looked for, but could not find, evidence of a direct link between a securities transaction and fraud because the SEC failed to present it. Pet App. 9a.-10a

Finally, even if there were a circuit split, it would not warrant review by this Court because this is a rarely litigated issue. Zandford can find no case published in the twenty years

since Kendrick was decided, in the Ninth Circuit or elsewhere, that uses Kendrick for the proposition put forth in the petition for certiorari.[20] Moreover, it is particularly telling that the SEC did not as much as cite Kendrick either in its brief in the court of appeals or in its petition for rehearing. Before the court of appeals, the SEC cited a single district court case, Henricksen v. Henricksen, 486 F. Supp. 622, 629 (E.D. Wis. 1980), Pet. App. 11a, as the only case directly on point, and never mentioned this twenty-year old decision of a sister court of appeals.

The other cases the petition relies on as inconsistent with the decision of the court of appeals here, but apparently not rising to conflict status, are Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979), and Allico Nat'l Corp. v. Amalgamated Meat Cutters, 397 F.2d 727 (7th Cir. 1968). Pet 16-17. Both of these cases are readily distinguishable from this case because they deal with conversions of specific bonds or stock that were wrongfully withheld from the lawful owner. See Mansbach, 598 F.2d at 1027 (finding a § 10(b) and Rule 10b-5 violation where a brokerage firm refused to return certain bonds, which had been pledged to it as collateral); Allico, 397 F.2d at 727 (finding a violation of federal securities laws involving a union's wrongful misappropriation of 25,000 shares of stock).

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[20] Zandford has found only one unpublished decision, United States v. Walls, 949 F.2d 400, No. 90-50412, 1991 WL 261632, at *2 (9th Cir. 1991), which cites Kendrick on this point. The Ninth Circuit found that Walls' use of his client's assets in five separate stock transactions without his client's knowledge constituted a violation of Rule 10b-5. Id. at *1. Walls cited Kendrick and incorrectly described it as a case where the broker had used client funds to purchase securities for his personal benefit. Id. at *2. Although it then quoted Kendrick for the proposition that the broker failed to disclose that he was acting beyond his authority in using customer funds, the court also found that the government had established that Walls was engaging in fraud when he engaged in numerous specific transactions involving securities. Id.

VI. THE DECISION IN THIS CASE IS NOT SUFFICIENTLY IMPORTANT TO WARRANT REVIEW BY THIS COURT.

This case does not pose an issue of national concern. To the extent that broker theft is a national problem, it is fully addressed by federal and state law and is not hampered by the decision of the court of appeals here. The SEC was only able to produce one 1981 district court case that it claimed presented a similar situation in which a broker sold securities and misappropriated the proceeds. Pet. App. 11a ("The SEC has advanced but one case in which a court has held that a broker who sells securities and misappropriates the proceeds has violated the federal securities laws, and that decision provides no analysis to support the holding.") (citing Henricksen, 486 F. Supp. at 629). Although the SEC claims that it has enforced the securities laws in its own proceedings on this basis for over 50 years, there are a limited number of reported actions over that 50 year period and none of the cases to which the SEC cites deal with discretionary accounts. Pet. 17 & n.6. Further, the petition cites to no reported cases where private litigants rely on this type of fraud when proceeding under § 10(b) or Rule 10b-5.

While the SEC plays a significant role in regulating the securities industry, it does not act alone. See Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 171 (1994) ("The [securities acts] create an extensive scheme of civil liability. The [SEC] may bring administrative actions and injunctive proceedings to enforce a variety of statutory provisions. Private plaintiffs may sue under express private rights of action contained in the Acts.") (emphasis added). Federal and state civil and criminal laws cover this type of theft and provide the government and private litigants with redress, without resort to the securities fraud laws. Further, through enforcement of its rules and regulations, self regulation by the National Association of

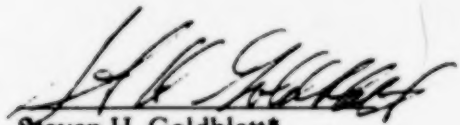
Securities Dealers ("NASD"), is also a significant means of policing the brokerage industry and remedying improper activity. See United States v. NASD, 422 U.S. 694, 710 n.19 (1975) (stating that "the industry . . . is afforded the initial opportunity to police its own practices"); Jones v. SEC, 115 F.3d 1173, 1178-82 (4th Cir. 1997) (generally discussing the overlapping and broad authority of the NASD and the SEC to enforce securities laws, including the NASD's ability to hold hearings to determine whether a member has defrauded a client, and subsequent ability to suspend a broker from trading or to cancel a broker's membership), cert. denied 523 U.S. 1072 (1998).

Finally, the SEC errs in its claim that a broad reading of the decision of the court of appeals would exempt "[d]eceptive conduct by brokers . . . includ[ing] churning customer accounts" from SEC regulation under § 10(b) and Rule 10b-5. Pet. 19. First, even the SEC acknowledged in the district court that the churning claims asserted in the complaint would not be proven by the criminal conviction. Opp. App. 16a n.1. Second, churning would easily meet the concern of the court of appeals that fraud be connected to a particular security or securities transaction because the repeated sales of securities to generate fees is precisely the type of fraud that is directly related to securities transactions. Pet. App. 9a-10a.

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted,



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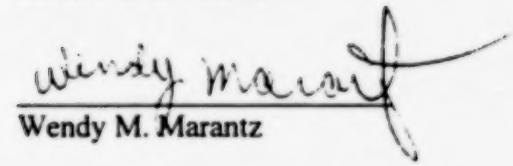

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(1)

No. 01-147

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 2001

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES ZANDFORD,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

APPENDIX TO
BRIEF FOR THE RESPONDENT IN OPPOSITION

18 pp

STATEMENT THAT THE PANEL DECISION CONFLICTS WITH DECISIONS OF THE SUPREME COURT AND THAT THE ISSUE SOUGHT TO BE REVIEWED IS OF EXCEPTIONAL IMPORTANCE

In this civil law enforcement action brought by the Securities and Exchange Commission, the defendant, a securities salesman, in a series of transactions sold a customer's securities while secretly intending to convert the proceeds of those sales to his own use. He misappropriated a total of $343,000 from his customer's securities account. On the basis of this clearly fraudulent conduct -- his repeated failure to disclose to his trusting customer that he intended to convert and was converting the proceeds of each sale -- he was convicted of thirteen counts of wire fraud. His conviction was affirmed by this Court. United States v. Zandford, 110 F.3d 62 (Table), 1997 WL 153822, at *1 (4th Cir. 1997). Yet, in this civil action brought by the Commission alleging the same fraudulent securities sales, a panel of this Court held in the attached opinion that the defendant's fraud was not committed "in connection with the purchase or sale of any security" and therefore was not prohibited by the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5. See Statutory Appendix hereto.

The panel's holding is contrary to the holdings and reasoning of controlling decisions of the Supreme Court. It is also contrary to the plain meaning of the statutory language and would seriously undermine the Commission's ability to carry out its responsibility, mandated by Congress, to protect brokerage

firm customers from dishonest brokers. The panel's decision would erase a major protection for investors, and would be contrary to more than half a century of Commission decisions involving the very same type of fraud. 1/

In holding that the defendant's fraud was not in connection with a sale of securities, the panel erroneously separated the fraud from the sale of securities. The panel stated that the "fraud lay in absconding with the proceeds," while there is "no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion." Opp. at 7-8. This is the precise reasoning that was rejected by a unanimous Supreme Court in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971), in holding that Section 10(b) was violated by a misrepresentation that a corporation selling bonds would receive the proceeds, when insiders actually intended to misappropriate the proceeds for their own use. The panel's attempt to distinguish Bankers Life on the ground that fraud by omission in this case somehow constitutes a lesser "connection" with the sale than fraud by false statement in Bankers Life has no support. The panel's bifurcation of the fraud and the sale is also contrary to the Supreme Court's decision in United States v. O'Hagan, 521 U.S. 642 (1997). The Court held in O'Hagan that the "in connection with" requirement was satisfied by the defendant's deception of a nonparticipant in the defendant's subsequent securities transactions.

1/ See, e.g., Calvert Sec. Corp., 35 SEC 141 (1953); D.S. Waddy & Co., 30 SEC 367 (1949).

AVAILABLE

The panel's expressed desire to avoid federalizing misconduct it believed should be relegated to state tort law was based on a misreading of the Supreme Court's decision in Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), and conflicts with the Supreme Court's decisions in both Bankers Life and Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991). Santa Fe's concern over the encroachment of federal law into areas traditionally regulated by state law was limited, as the Court later made clear in Virginia Bankshares, to situations where there is no deceptive conduct. The irrelevance of state law was also expressly made clear in Bankers Life. The standards for securities fraud are of federal origin, having been specifically enacted by Congress to address the special needs for investor protection occasioned by investments in securities. See Section 2 of the Exchange Act, 15 U.S.C. 78b.

The issue on which the Commission seeks rehearing -- whether the defendant's failure to tell his customer that he intended to convert the proceeds of each of the securities sales was "in connection with" those sales -- is a matter of exceptional importance. Section 10(b) and Rule 10b-5 are key provisions upon which the Commission relies in virtually every case in which it seeks injunctions or other judicial remedies, or imposes administrative sanctions, against persons who have engaged in fraudulent conduct. The panel decision erroneously restricts the scope of these provisions in contravention of the statutory

language and Supreme Court precedent and, unless set aside, will seriously weaken the safeguards that Congress enacted to protect investors.

ARGUMENT

ZANDFORD'S FRAUDULENT CONDUCT -- HIS FAILURE TO DISCLOSE HIS INTENT TO CONVERT THE PROCEEDS OF EACH SALE -- WAS "IN CONNECTION WITH THE PURCHASE OR SALE OF A[] SECURITY."

A. The Panel Erred in Viewing Zandford's Sales of Securities as Separable from His Fraud.

1. Zandford, a securities professional, deceived his customer when he sold his customer's securities without disclosing his intent to convert the proceeds to his own use.

The panel decision states that to satisfy the "in connection with" requirement, "'the fraud must have been integral to the * * * purchase or sale of the security.'" Op. at 7 (quoting Flickinger v. Harold C. Brown & Co., 947 F.2d 595, 598 (2d Cir. 1991)). The panel, however, erred in applying that principle. The error stems from the panel's apparent conclusion that Zandford's deception was his misappropriation of the proceeds of the sales of his customer's securities. In fact, Zandford's deception was his failure to disclose to his customer, as he had a duty to do, that he was selling the securities for the purpose of misappropriating the proceeds. Clearly, that deception was "integral" to the sales. Indeed, Zandford's customer would not have permitted him to sell the securities if Zandford had told him he was planning to steal the proceeds. Moreover, because the deception occurred at the time of the sale, the fraud that is the basis for the Commission's action was complete once the securities were sold.

Fraud occurred when Zandford sold his customer's securities even if he did not make affirmative false statements. As a stockbroker, Zandford had a well-established duty to disclose material information to his customer. Nothing could be more material to a broker's customer than his broker's intention to steal the money realized from the sale of his securities. The broker's duty to disclose his intent is based on his implicit representation to his customer throughout the period of their relationship that he would handle the customer's funds and securities honestly and in accordance with the continuous fiduciary duty he owed to his customer. See Chiarella v. United States, 445 U.S. 222, 228-30 (1980) ("the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them'"). 2/ The existence of the duty to disclose, which Zandford and the panel do not and could not dispute, means that Zandford defrauded his customer as soon as he initiated each of his many improper sales transactions without notifying the customer of the sale and of his intent to convert the customer's assets.

2. The panel's conclusion that Zandford's sales were separate from his fraud is inconsistent with Supreme Court precedent.

Supreme Court precedent establishes that Zandford's fraud

2/ The panel acknowledges that "Zandford breached a fiduciary duty to [his customer]." Op. at 11. See also United States v. Russo, 74 F.3d 1383, 1392 (2d Cir.), cert. denied, 519 U.S. 927 (1996) (broker seeking to benefit from an illegal, self-created scheme has a duty to disclose information).

occurred at the time of the sale, and Zandford's full disclosure to his customer of his reasons for selling the securities would have enabled his customer to prevent him from consummating the sales. Consequently, the general language in Hunt about the adequacy of common law has no application here.

CONCLUSION

The panel decision improperly limited the plain language of Section 10(b) and Rule 10b-5 and misapplied relevant Supreme Court precedent by separating the sale of securities and the customer conversion of the proceeds and by considering whether the customer could bring a common law claim against Zandford. This Court should grant the Commission's petition for panel rehearing or rehearing en banc and affirm the district court order granting summary judgment.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 99-1733

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

CHARLES ZANDFORD,

Defendant-Appellant,

On Appeal from the United States District Court
for the District of Maryland

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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MEYER EISENBERG
Deputy General Counsel

140. 2/

On March 24, 1999, 22 days after the district court's final order, Zandford filed a motion for reconsideration with the district court. JA 143-45. In this motion, Zandford, once again, requested permission to file a brief opposing the Commission's motion for partial summary judgment. Id. Zandford never filed a motion for enlargement of time to file a notice of appeal. Nevertheless, on May 27, 1999, he filed an untimely notice of appeal. On June 2, 1999, the district court entered an order denying Zandford's motion for reconsideration, nunc pro tunc May 24, 1999. In addition, treating Zandford's motion for reconsideration as a motion for enlargement of time under Fed. R. App. P. 4(a)(5) -- even though the motion made no such request -- the district court ordered that Zandford could file his notice of appeal on or before May 27, 1999.

2/ The Commission did not move for summary judgment on its allegations of excessive trading. As a result, the district court did not address these allegations in its order granting summary judgment. Because the Commission is unlikely to receive any further relief by pursuing its excessive trading claims, the Commission has no intention of taking any further action against Zandford. Consequently, the Commission did not question the district court's decision to enter final judgment even though the Commission moved only for partial summary judgment.

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

SECURITIES AND EXCHANGE COMMISSION, Plaintiff,	:	CIVIL ACTION NO. AMD 95-CV-2826
v.	:	
CHARLES ZANFORD Defendant.	:	

PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S MEMORANDUM OF LAW IN RESPONSE TO DEFENDANT'S MOTION TO CONDUCT LIMITED DISCOVERY

I. Introduction

Plaintiff United States Securities and Exchange Commission ("Commission"), by and through its attorney, Brian Carroll, Senior Trial Counsel, files with the Court this Memorandum of Law in Response to Defendant's Motion to Conduct Limited Discovery. Because the Commission's pending Motion for Partial Summary Judgement, Permanent Injunction, and Disgorgement, with prejudgment interest ("motion for partial summary judgement"), is based upon the collateral estoppel effect of the defendant's criminal conviction, defendant's motion to conduct limited discovery should be denied.

II. Background

On April 19, 1998, the Commission filed with the Court its motion for partial summary judgement. This motion is based upon the collateral estoppel effect of the defendant's criminal

conviction for wire fraud. Defendant's criminal conviction was upheld by the Fourth Circuit of the Court of Appeals. See United States v. Zanford, 110 F.3d 62, 1997 WL 153822 (4th Cir. (Md.)) (a copy of which is attached to the Commission's Memorandum of Law in Support of Plaintiff Securities and Exchange Commission's Motion for Partial Summary Judgment, Permanent Injunction and Disgorgement, with prejudgment interest ("Memorandum"), as Exhibit D.).

Defendant now seeks leave to conduct discovery in order to respond to the Commission's motion for partial summary judgement.

The Commission requested and was permitted until May 22, 1998 to file this response to defendant's motion to conduct discovery.

III. Legal Argument

A. Defendant is Barred from Relitigating Facts Established by His Conviction

The Commission's motion for partial summary judgement is based exclusively on the application of the doctrine of collateral estoppel. Under the doctrine of collateral estoppel[1],

[1] Black's Law Dictionary defines collateral estoppel as follows:

> Prior judgment between same parties on different cause of action is an estoppel as to those matters in issue or points controverted, on determination of which finding or verdict was rendered. E. I. duPont de Nemours & Co. v. Union Carbide Corp., D.C. Ill., 250 F.Supp. 816, 819. When an issue of ultimate fact has been determined by a valid judgment, that issue cannot be again litigated between the same parties in future litigation. City of Joseph v. Johnson, Mo.App., 539

the defendant is barred from relitigating facts and contesting liability on claims in the Complaint based on conduct for which he has already been convicted. Memorandum at pp. 5-7. This doctrine is intended to save courts and litigants from the waste and burden of relitigating issues previously established. Memorandum at pp. 5-7.

Here, defendant seeks, through his request for discovery, to relitigate the facts and issues established by his criminal conviction. This attempt to relitigate, however, is barred by the doctrine of collateral estoppel. Moreover, any discovery by defendant would be irrelevant because the facts and issues relied upon by the Commission in it's motion for partial summary judgement are based upon defendant's criminal conviction, which can not be impeached or undermined.

Finally, defendant fails completely to undermine, by any measure, the applicability of the doctrine of collateral estoppel to this case and its preclusive effect on litigating the facts and issues established by defendant's criminal conviction. Indeed, defendant simply ignores the doctrine of collateral estoppel.

S.W.2d 784, 785.
As a bar to relitigating an issue which has already been tried between the same parties or their privies, it must be pleaded affirmatively. Fed. R. Civil P. 8(c). It is applicable to criminal cases. Ashe v. Swenson, 397 U.S. 436, 443-444, 90 S.Ct. 1189, 1194, 25 L.Ed.2d 469.
Black's Law Dictionary, Fifth Edition, 1979, at p. 237.

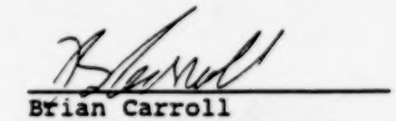
B. Defendant Misapprehends Rule 56

Defendant is not entitled to discovery under Federal Rule of Civil Procedure Rule 56. Because the Commission is relying upon the defendant's criminal conviction and the application of the doctrine of collateral estoppel, defendant discovery would be irrelevant to the pending motion for partial summary judgment. Moreover, defendant's request for discovery fails to comply with the requirements of Rule 56.

IV. Conclusion

For the forgoing reasons, defendant's motion to conduct limited discovery should be denied.

Respectfully Submitted,



Brian Carroll
Senior Trial Counsel
Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION

Date: May 21, 1998

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. CHARLES ZANFORD Defendant.	:	CIVIL ACTION NO. AMD 95-CV-2826

PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S MOTION FOR PARTIAL SUMMARY JUDGMENT, PERMANENT INJUNCTION, AND DISGORGEMENT, WITH PREJUDGMENT INTEREST

Plaintiff Securities and Exchange Commission respectfully moves pursuant to Fed. R. Civ. P. 56 for partial summary judgment against defendant Charles Zanford based upon its allegations of misappropriation. The Commission seeks a permanent injunction against Zanford enjoining him from future violations of the securities laws, and disgorgement of ill-gotten gains in the amount of $343,000, plus prejudgment interest of $309,406. In support of its motion, the Commission relies upon the criminal conviction of Charles Zanford in United States v. Charles Zanford (Criminal No. WN-94-0165), the memorandum of law in support of this motion and all exhibits thereto.

Respectfully Submitted,

Brian Carroll
Senior Trial Counsel
Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION

Date: April 15, 1998

BEST AVAILABLE

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. CHARLES ZANFORD Defendant.	:	CIVIL ACTION NO. AMD 95-CV-2826

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S MOTION FOR PARTIAL SUMMARY JUDGMENT, PERMANENT INJUNCTION AND DISGORGEMENT, WITH PREJUDMENT INTEREST

I. Preliminary Statement

Plaintiff Securities and Exchange Commission ("Commission") respectfully submits this memorandum in support of its motion for summary judgment against defendant Charles Zanford ("Zanford") pursuant to Rule 56 of the Federal Rules of Civil Procedure. The Commission also seeks a permanent injunction against Zanford enjoining him from future violations of the securities laws, disgorgement of ill-gotten gains in the amount of $343,000, plus prejudgment interest of $309,406.

The Commission's motion is based on the collateral estoppel effect of Zanford's criminal conviction in the District of Maryland on thirteen counts of wire fraud. 18 U.S.C. Section 1343. (U.S. v. Charles Zanford, Criminal No. WN-94-0165). The facts underlying Zanford's criminal case are identical to those alleged under the Commission's general factual allegations and, more specifically, the misappropriation allegations of the

instant complaint.[1] At issue in the motion, the Complaint charges Zanford with misappropriation of investor funds from an investment account in violation of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. Section 77q(a); Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b); and Rule 10b-5, 17 C.F.R. 240.10b-5, thereunder.

Because the jury has already spoken regarding Zanford's liability, there are no genuine issues of material fact remaining for trial. Zanford had a full and fair opportunity to litigate these claims; he lost and is collaterally estopped from relitigating the same facts. Therefore, the Commission is entitled to judgment as a matter of law.

II. Statement of Facts

A. Zanford's Criminal Trial

The facts underlying Zanford's criminal trial are established by the Superseding Indictment (Exhibit A), Verdict Form (Exhibit B), Criminal Judgement (Exhibit C) and the opinion of the Fourth Circuit Court of Appeals, U.S. v. Zanford, 110 F.3d 62, 1997 WL 153822 (4th Cir. (Md.)) ("Appellate Opinion") (Exhibit D). In addition, a copy of the trial judge's jury

[1] By way of this motion for partial summary judgement, the Commission does not seek judgement on its allegations of excessive trading by Zanford. Complaint at 5-6. Neither the superseding indictment nor the criminal conviction against Zanford addresses these allegations. Hence, the Commission reserves on these allegations.

charge in Zanford's criminal trial is attached. Exhibit E.

On July 25, 1995, following a seven day trial, a jury sitting in the United States District Court for the District of Maryland convicted Zanford on thirteen counts of wire fraud. See Verdict sheet. Exhibit B.

The facts underlying Zanford's conviction are as follows. From May, 1987 to February, 1991, Zanford was employed as a stockbroker in the Bethesda, Maryland office of the brokerage firm of Dominick & Dominick. Appellate Opinion at 1. (Exhibit C) and Superseding Indictment at 1 (Exhibit A). As part of his scheme and artifice to defraud, Zanford convinced William Wood ("Wood"), and his daughter, Diane Okstulski ("Okstulski"), to open a joint investment account at Dominick & Dominick with Zanford acting as their stockbroker. Appellate Opinion at 1. (Exhibit C) and Superseding Indictment at 2 (Exhibit A).

During the period that he dealt with Zanford, Wood was "virtually blind, completely incompetent and medically disabled." Appellate Opinion at 3. (Exhibit C). Wood died in 1991. Appellate Opinion at 1. (Exhibit C). In addition, Okstulski suffered from "multiple personality disorder." Appellate Opinion at 1. (Exhibit C).

As a further part of his scheme and artifice to defraud, Zanford persuaded Wood and Okstulski to entrust him with $419,255, which was deposited in their joint investment account at Dominick and Dominick and intended for the purchase of conservative investments. Appellate Opinion at 1. (Exhibit C)

Supreme Court, U.S.

OCT 9 2001

CLERK

(3)

No. 01-147

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

No. 01-147

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

This case presents the question whether a stockbroker violates Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Securities Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. 240.10b-5, when he "sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so." Pet. i. The court of appeals held that such conduct does not violate Section 10(b) and Rule 10b-5. Its decision conflicts with this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), as well as the decision of the Ninth Circuit in *United States* v. *Kendrick*, 692 F.2d 1262 (1982), cert. denied, 461 U.S. 914 (1983). For those reasons, and because the decision in this case, if allowed to stand, will significantly impair the SEC's ability to enforce the securities laws for the protection of investors, this Court's review is warranted.

1. a. Respondent contends (Br. in Opp. 9-12) that the petition for a writ of certiorari should be denied because (he asserts) the SEC is asking this Court to decide a different question than the one decided by the court of appeals. Specifically, respondent argues that the court of appeals decided whether the "in connection with" requirement of Section 10(b) is satisfied by the charges in the indictment that led to respondent's criminal conviction, while the SEC seeks review of whether that requirement is satisfied by the allegations in the SEC's civil complaint. Respondent is wrong.

The court of appeals summarized in its opinion both the charges in the indictment and the allegations in the civil complaint, without suggesting that the facts in the criminal case differ in any material respect from the allegations in the civil complaint. See Pet. App. 2a (indictment); *id.* at 3a (complaint); see also *id.* at 5a. Then, in the pertinent portion of its opinion, the court of appeals stated that the "precise issue before [the court]" was whether the fraud alleged by the SEC—that "[respondent] defrauded the Woods by failing to inform them that he intended to sell their securities in order to obtain the proceeds for himself"—"is sufficiently connected to a securities transaction" to constitute a violation of Section 10(b) and Rule 10b-5. *Id.* at 8a. That is the very same question presented in the petition for a writ of certiorari. See Pet. i. Because the court of appeals resolved that question against the SEC as a matter of law, the court "remand[ed] with directions to dismiss the case." Pet. App. 2a; see also *id.* at 14a. Respondent's assertion (Br. in Opp. 9) that "[t]he issue presented for review was neither pressed by the

SEC below nor passed upon by the court of appeals" is thus simply wrong.[1]

b. Respondent also errs in contending (Br. in Opp. 12-16) that, if this Court grants the petition, it will have to determine whether to decide the case based on the facts alleged in the SEC's complaint or the (purportedly different) facts charged in the criminal indictment. The petition presents no question concerning the collateral estoppel effect of respondent's indictment and conviction on this civil case, and there is in any event no difference between the indictment and the complaint that

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[1] Respondent creates some confusion by taking issue (Br. in Opp. 9, 10) with the statement in a footnote in the petition that the court of appeals "dismissed the Commission's complaint for failure to state a claim." Pet. 7 n.2. Respondent contends (Br. in Opp. 10) that the court of appeals' decision should instead be characterized as a sua sponte grant of summary judgment in favor of respondent. That contention finds no support in the pertinent portion of the court's opinion, which begins by explaining what is necessary "[t]o *state a claim*" (Pet. App. 6a (emphasis added)) under Section 10(b) and Rule 10b-5, then recites that the issue before the court is "whether [respondent's] *alleged* fraud is sufficiently connected to a securities transaction" (*id.* at 8a (emphasis added)), and concludes by holding that respondent's "*alleged* fraudulent activities were not sufficiently connected to a securities transaction to merit liability" (*id.* at 14a (emphasis added)) and directing the district court to "*dismiss*" the case (*ibid.* (emphasis added)).

In any event, it is irrelevant for present purposes how the court of appeals' disposition of the case is characterized. The critical point is that the court held that respondent's conduct, as alleged by the SEC, was outside the scope of Section 10(b) and Rule 10b-5 as a matter of law. Thus, contrary to respondent's assertion (Br. in Opp. 9, 10 n.6, 11), the government's contention is not that the court of appeals' disposition of the case is *procedurally* unfair to the SEC because the court, after having issued its ruling on the merits, should then have remanded the case to the district court rather than dismissing it outright. The contention is that the court of appeals' ruling on the merits is *substantively* incorrect, and that its judgment ordering dismissal should be reversed on *that* ground.

has any bearing on the resolution of the question presented.

i. Respondent's focus on the indictment stems from his failure to recognize that the court of appeals' decision consisted of two separate rulings, only one of which is before this Court. In its first ruling, the court reversed the district court's grant of summary judgment for the SEC, holding that respondent's criminal conviction did not, under the doctrine of collateral estoppel, establish all of the legal elements of the violations of Section 10(b) and Rule 10b-5 alleged in the complaint. Pet. App. 4a-5a. In its second ruling, the court went on to hold that the facts alleged by the SEC in its complaint do not even state a claim under Section 10(b) and Rule 10b-5. *Id.* at 8a-14a. In that portion of its opinion, the court made no mention at all of the indictment or criminal conviction—which had been submitted by the SEC with its motion for summary judgment to *prove* what had only been alleged in the complaint—and instead properly focused on what the SEC has "alleged," which obviously requires reference to the complaint. See note 1, *supra*; see also Pet. App. 3a (court summarizes allegations in SEC's complaint); *id.* at 28a-29a (relevant portions of complaint).

The petition for a writ of certiorari seeks review of only the latter ruling, not the court's holding that respondent's criminal conviction did not establish all of the legal elements of a violation of Section 10(b) and Rule 10b-5 under the doctrine of collateral estoppel. For that reason, and contrary to respondent's contention (Br. in Opp. 15-16, 19-20), there is no occasion for this Court to consider any issues concerning collateral estoppel or the facts set forth in the indictment or proven at trial in the criminal case.

The only facts that this Court need consider in deciding the question presented are those on which the court

of appeals itself relied. The court of appeals succinctly stated those facts, based on what the SEC "alleges": that respondent "defrauded the Woods by failing to inform them that he intended to sell their securities in order to obtain the proceeds for himself." Pet. App. 8a.

ii. In any event, nothing in the court of appeals' opinion suggests that the allegations in the SEC's complaint differ in any material respect from those on which the charges in the indictment or respondent's criminal conviction were based. Respondent identifies only one supposed difference—that the indictment "refers to only one investment account" but the "complaint contains several allegations regarding a mutual fund account." Br. in Opp. 13-14. The court of appeals, however, expressly stated *its* understanding that the "first count [of the indictment] maintained that [respondent] sold the Woods' shares of a mutual fund in order to use the proceeds for his own benefit." Pet. App. 2a. Indeed, that was how the court of appeals had previously described the first count of the indictment when it affirmed respondent's conviction. See *id.* at 35a ("The first count related to money [respondent] obtained from selling the Woods' shares in a mutual fund.").

Even if the indictment had not encompassed respondent's fraudulent sales of the mutual fund shares but only his fraudulent sales of the Woods' other securities in their brokerage account, that would have no bearing on the resolution of the legal issue decided by the court of appeals and presented by the petition for certiorari. Respondent contends (Br. in Opp. 14-15) that the difference is "critical" because the court of appeals noted that the Woods' brokerage account was a discretionary one, in which respondent could trade securities without obtaining the Woods' prior approval. See Pet. App. 10a. Respondent also implies (without actually stating) that

he did not have comparable authority over the Woods' mutual fund holdings. See Br. in Opp. 15. In fact, nothing in the record suggests that respondent's authority over the Woods' mutual fund holdings was any different than his authority over the brokerage account, and the SEC does not contend that it was.

Moreover, whether respondent had discretionary authority to sell the Woods' securities (including their mutual funds) or first had to obtain their permission for any sales has no bearing on the question whether respondent's deception concerning his intent to misappropriate the sales proceeds was "in connection with" his sale of the Woods' securities. The requisite connection was present because the sale of the securities was the means by which respondent generated the cash he stole, and his deception concerning his intent in selling the securities left the Woods without information that would have enabled them to act to prevent those sales. See Pet. 9.

Nor does respondent's discretionary authority to trade without obtaining prior approval from the Woods render his conduct any less fraudulent and unauthorized. Respondent's discretionary authority to trade was limited to transactions for the Woods' benefit. See Restatement (Second) of Agency § 387 (1958) ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."). Absent disclosure to and consent by the Woods, respondent could not exercise his discretionary authority by selling their securities in order to use the proceeds to enrich himself. Cf. *United States* v. *O'Hagan*, 521 U.S. 642, 654-655 (1997).

2. Respondent is also incorrect in asserting (Br. in Opp. 17-22) that the court of appeals' decision does not conflict with any decision of this Court or any court of

appeals. As explained in the petition (at 13-17), the decision in this case conflicts both with this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), and with the Ninth Circuit's decision in *United States* v. *Kendrick*, 692 F.2d 1262 (1982), cert. denied, 461 U.S. 914 (1983).

a. Respondent attempts to distinguish *Bankers Life* by arguing (Br. in Opp. 19) that it involved a misrepresentation that induced the securities sale. The facts in this case, however, are not materially different. As noted by the court of appeals, the SEC alleged that respondent defrauded the Woods in connection with securities sales by failing to inform them that he intended to sell their securities in order to misappropriate the proceeds. See Pet. App. 8a. Respondent's failure to disclose his plans deprived the Woods of the opportunity to prevent the sales. Thus, respondent's failure to disclose was instrumental to the sales in this case just as much as the misrepresentation in *Bankers Life* was instrumental to the sale in that case. Whether the deception that causes a securities transaction is accomplished through an omission or an affirmative misrepresentation has no legal significance with regard to whether the deception is "in connection with the purchase or sale of any security," as required by Section 10(b). See Pet. 14-15; *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972); *Chiarella* v. *United States*, 445 U.S. 222, 228 (1980).

Respondent also cannot distinguish *Bankers Life* on the ground that the court of appeals "correctly concluded" that his "fraudulent activities were not sufficiently connected to a securities transaction where the evidence established by the SEC based on its collateral estoppel theory only established that funds were converted from a securities account and the actual role of securities in the fraud is not established" (Br. in Opp.

19-20). As explained above (see pp. 3-5, *supra*), the question of what the SEC affirmatively established (not merely alleged) by relying on respondent's criminal conviction is not presented in the certiorari petition. Furthermore, the distinction that respondent would draw rests on a mischaracterization of the basis for the court of appeals' decision. The decision did not rest on a factual conclusion that the SEC failed to establish the role of securities in respondent's fraud, but on a legal conclusion that respondent did not violate Section 10(b) even if, as the SEC alleged, he "defrauded the Woods by failing to inform them that he intended to sell their securities in order to obtain the proceeds for himself." Pet. App. 8a.

b. Respondent's attempt (Br. in Opp. 20) to explain away the conflict with the Ninth Circuit's decision in *Kendrick* is based on the irrelevant distinction that *Kendrick* "involved securities in non-discretionary margin accounts." As discussed above, whether the securities sales occurred in a discretionary or a non-discretionary account has no bearing on the legal issue in this case. See p. 6, *supra*. Respondent also incorrectly contends (Br. in Opp. 20) that, in *Kendrick*, there was a "direct link" with the securities transaction that is lacking in this case. Just as Kendrick was engaged in fraud when he "caused Dean Witter to issue the checks" on the margin account in order to convert the money to his own use (692 F.2d at 1265), so too respondent was engaged in fraud when he caused the Woods' securities to be liquidated in order to convert to his own use the money "generated" by the sales (Pet. App. 2a; see also *id.* at 28a, 41a).

c. Contrary to respondent's contention (Br. in Opp. 18), the petition's reliance on *O'Hagan* (see Pet. 9-13) does not "wrench[] *O'Hagan* from the context in which it was decided." The rationale of this Court in finding

that O'Hagan's fraudulent conduct was "in connection with" his securities transactions applies to this case. See Pet. 9-10. This Court stated in *O'Hagan* that the "in connection with" element "is satisfied because the fiduciary's fraud is consummated * * * when the fiduciary, * * * without disclosure to his principal," uses the principal's confidential information in trading securities for personal profit. 521 U.S. at 656. Similarly, in this case, respondent's fraud was consummated when he sold the securities of his principals and converted the proceeds for his own benefit, without disclosing his intentions to them.

3. Finally, contrary to respondent's assertions (Br. in Opp. 22-23), the holding of the court of appeals that a stockbroker's fraudulent conversion of securities and their proceeds does not violate Section 10(b) and Rule 10b-5 will significantly impair the SEC's ability to protect investors. In fiscal year 2000 alone, the SEC used those general antifraud provisions to bring 16 administrative proceedings and civil actions against securities firms and their personnel for fraudulently misappropriating customer property.[2]

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[2] *David Barroso, Jr.*, Exchange Act Release No. 43,386, 73 SEC Docket 1396 (Sept. 29, 2000); *Douglas J. Hopwood*, Exchange Act Release No. 43,353, 73 SEC Docket 1125 (Sept. 26, 2000); *Cheryl A. Rodgers*, Exchange Act Release No. 43,351, 73 SEC Docket 1121 (Sept. 26, 2000); *SEC* v. *Christie*, Litigation Release No. 16,724, 73 SEC Docket 1348 (Sept. 26, 2000); *SEC* v. *Smith*, Litigation Release No. 16,698, 73 SEC Docket 910 (Sept. 12, 2000); *SEC* v. *Meridian Asset Mgmt., Inc.*, Litigation Release No. 16,638, 72 SEC Docket 3064 (July 31, 2000); *Janney Montgomery Scott LLC & Norman T. Wilde, Jr.*, Exchange Act Release No. 43,050, 72 SEC Docket 2663 (July 18, 2000); *Thomas V. Conwell*, Exchange Act Release No. 43,006, 72 SEC Docket 2500 (July 3, 2000); *Shan Michael Hefley*, Exchange Act Release No. 42,625, 72 SEC Docket 259 (Apr. 5, 2000); *SEC* v. *Hefley*, Litigation Release No. 16,479, 71 SEC Docket 2839 (Mar. 21, 2000); *Donald J. Martineau*,

Although it is true, as respondent points out (Br. in Opp. 22), that actions against brokers who fraudulently convert securities or securities proceeds from brokerage accounts could also be brought by persons or entities other than the SEC under other state and federal laws, this Court and Congress have made clear that the existence of remedies under other laws does not preclude the existence of an action under the federal securities laws. *Bankers Life*, 404 U.S. at 12; 15 U.S.C. 78bb(a) (1994 & Supp. V 1999) (subject to limited exceptions not relevant here, "the rights and remedies provided by [the Securities Exchange Act] shall be in addition to any and all other rights and remedies that may exist in law and equity"). It is essential that the agency principally responsible for enforcing the federal securities laws be able to take action to protect brokerage firm customers from fraudulent conversions of their assets.

* * * * *

For the reasons stated above and in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

OCTOBER 2001

Exchange Act Release No. 42,422, 71 SEC Docket 1994 (Feb. 14, 2000); *SEC* v. *Conwell*, Litigation Release No. 16,420, 71 SEC Docket 1675 (Feb. 1, 2000); *SEC* v. *Martineau*, Litigation Release No. 16,406, 71 SEC Docket 1304 (Jan. 10, 2000); *SEC* v. *Sunpoint Sec., Inc.*, Litigation Release No. 16,366, 71 SEC Docket 464 (Nov. 19, 1999); *SEC* v. *Bulas*, Litigation Release No. 16,337, 70 SEC Docket 2887 (Oct. 15, 1999); *SEC* v. *Tropeano*, Litigation Release No. 16,327, 70 SEC Docket 2502 (Oct. 5, 1999).

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No. 01-147

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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QUESTION PRESENTED

Whether a stockbroker's fraud is "in connection with the * * * sale" of securities under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, when the stockbroker sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so.

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No. 01-147

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 238 F.3d 559. The memorandum and order of the district court granting the Securities and Exchange Commission's motion for summary judgment (Pet. App. 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on January 26, 2001. A petition for rehearing was denied on March 26, 2001 (Pet. App. 51a). On June 16, 2001, the Chief Justice extended the time within which to file a petition for a writ of certiorari to and including July 24, 2001. The petition was filed on that date and was granted on November 8, 2001. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTE AND RULE INVOLVED

The texts of 15 U.S.C. 78j(b) and 17 C.F.R. 240.10b-5 are reproduced in the appendix to the petition for a writ of certiorari (Pet. App. 52a-53a).

STATEMENT

1. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b) (*reprinted in full at* Pet. App. 52a). SEC Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5 (*reprinted in full at* Pet. App. 52a-53a).

2. In 1987, respondent Charles Zandford, a stockbroker, convinced William Wood to open a joint brokerage account for Wood and his daughter, Diane Wood Okstulski. Wood was an elderly man in poor health, and his daughter was both mentally retarded and mentally ill. Wood and Okstulski (the Woods) entrusted respondent with $419,255 to "conservatively invest" in his discretion. Respondent, however, methodically siphoned money from the Woods' investment account to

accounts that respondent owned or controlled. He did so by repeatedly selling securities in the Woods' account so that he could acquire the proceeds. He never disclosed his activities to the Woods. By September 1990, all of the Woods' funds were gone. Pet. App. 2a, 10a, 28a-29a, 34a, 41a-42a.

In April 1995, a federal grand jury in the District of Maryland indicted respondent on thirteen counts of wire fraud in violation of 18 U.S.C. 1343. Pet. App. 2a; see *id.* at 40a-50a (Superseding Indictment). The indictment charged respondent with "devis[ing] a scheme and artifice to defraud and to obtain money and property from [the Woods] by means of false and fraudulent pretenses, representations, and promises." *Id.* at 41a. Specifically, it alleged that respondent had "caused checks to be issued against the security positions of [the Woods] and made payable to [himself], thereby causing their securities to be liquidated." *Ibid.* The indictment further alleged that respondent "sold securities in [the Woods'] joint investment account * * * and then made personal use of the money." *Id.* at 42a. A jury found respondent guilty of all of the wire fraud charges, and the district court sentenced him to 52 months in prison and ordered him to make restitution in the amount of $10,800. *Id.* at 2a. The United States Court of Appeals for the Fourth Circuit, finding "ample direct and circumstantial evidence showing that [respondent] had engaged in a scheme to defraud the Woods" (*id.* at 36a), affirmed his convictions and sentence. *Id.* at 33a-39a.

3. In September 1995, the SEC brought this civil law enforcement action against respondent in the United States District Court for the District of Maryland. Pet. App. 25a-32a. The Commission's complaint alleged that, between May and June 1988, without the Woods' knowledge or consent, respondent issued

checks to himself drawn on the Woods' joint mutual fund account, and that the funds to pay the checks were obtained through the sale of mutual fund shares in that account. *Id.* at 28a. The complaint further alleged that, on several occasions between July 1988 and June 1990, respondent sold mutual fund shares or other securities owned by the Woods without their knowledge or consent and misappropriated the proceeds of the sales. *Id.* at 29a. The complaint charged that respondent thereby violated Section 10(b) and Rule 10b-5. *Id.* at 30a-31a. The Commission sought injunctive relief, including an order enjoining respondent from violating Section 10(b) and Rule 10b-5 and requiring him to disgorge the proceeds of his fraudulent conduct. *Id.* at 25a-32a.[1]

In April 1998, the Commission filed a motion for summary judgment in which it relied on the collateral estoppel effect of respondent's criminal convictions to establish that he intentionally defrauded the Woods. Respondent filed a motion to conduct discovery, but he did not move for summary judgment. In March 1999, the district court denied respondent's motion for discovery, granted the Commission's motion for summary judgment, enjoined respondent from future violations of the antifraud provisions, and ordered him to disgorge $343,000 in illegally obtained funds. Pet. App. 3a, 15a-24a.

[1] The Commission's complaint also alleged that respondent violated Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a). Pet. App. 25a, 30a-31a. The Commission did not seek this Court's review of the question whether the complaint stated a claim under Section 17(a) because it did not identify a square conflict between the decision of the court of appeals in this case and decisions of this Court or other courts of appeals on that question. That question is therefore not before the Court.

4. Respondent appealed. The United States Court of Appeals for the Fourth Circuit not only reversed the district court's grant of summary judgment in favor of the SEC, but also remanded the case with directions to dismiss the complaint. Pet. App. 1a-14a. As an initial matter, the court held that the district court had erred in granting summary judgment for the SEC based on collateral estoppel. *Id.* at 4a-5a. The court ruled that respondent's criminal conviction did not establish all the legal elements of the violations of Section 10(b) and Rule 10b-5 alleged in the Commission's civil complaint. In particular, the court noted that, in order to find respondent guilty of wire fraud, the jury did not need to determine that his fraud was "in connection with the purchase or sale of securities." *Id.* at 5a. Thus, the court reasoned, even if "the criminal trial established the fact that [respondent] sold securities as part of a scheme to misappropriate proceeds," respondent's criminal convictions did not collaterally estop him from contesting the district court's "legal conclusion" that "such a scheme satisfies the 'in connection with' requirement" of Section 10(b). *Ibid.*

Next, in the portion of the opinion relevant to the issue now before this Court, the court of appeals concluded that the SEC's allegations concerning respondent's scheme to sell the Woods' securities and misappropriate the proceeds did not state a claim for relief under Section 10(b) and Rule 10b-5. Pet. App. 5a-14a. The court of appeals first explained that, "to state a claim under § 10(b) of the Exchange Act and Rule 10b-5," the Commission must show that respondent's fraud was "in connection with" the purchase or sale of any security. *Id.* at 6a (quoting 15 U.S.C. 78j(b)). The court noted that the SEC "allege[d] that [respondent] defrauded the Woods by failing to inform them that he

intended to sell their securities in order to obtain the proceeds for himself." *Id.* at 8a. The court further noted that the SEC argued that this omission was fraudulent because respondent, as the Woods' agent, had a duty to disclose material information to them, and that the omission was in connection with respondent's sale of the Woods' securities. *Ibid.*

The court of appeals concluded that respondent's "alleged fraudulent activities were not sufficiently connected to a securities transaction." Pet. App. 14a. In the court's view, respondent's "securities sales were incidental to his scheme to defraud. [His] fraud lay in absconding with the proceeds of the sales. The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion." *Id.* at 9a. In explaining why it determined that respondent's conduct was not "in connection with" any securities transaction, the court stated that respondent did not mislead "the Woods about the relative merits or value of particular securities." *Ibid.* The court further noted that respondent's fraudulent "statements or omissions were not about a particular security" (*id.* at 13a), "did not make any reference to the attributes of a specific security" (*id.* at 10a), and did not "induce the Woods or anyone else to buy or sell a particular stock" (*id.* at 13a). The court also expressed the view that "the goal of § 10(b) would not be served by expanding its scope to include 'claims amounting to breach of contract or common law fraud which have long been the staples of state law.'" *Id.* at 8a (quoting *Hunt* v. *Robinson*, 852 F.2d 786, 787-788 (4th Cir. 1988)). Finally, the court observed that, "while [respondent] breached a fiduciary duty to the Woods, the Supreme Court has emphasized that the federal securities laws are not an open-ended breach of fiduciary duty

ban." *Id.* at 14a (citing *United States* v. *O'Hagan*, 521 U.S. 642, 655 (1997); *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462 (1977)). The court of appeals accordingly remanded the case to the district court "with directions to dismiss it." *Ibid.*[2]

SUMMARY OF ARGUMENT

A stockbroker violates Section 10(b) and Rule 10b-5 when, without authorization or disclosure, he sells customer securities for his own benefit and converts the proceeds to his own use. The SEC has so interpreted Section 10(b) and Rule 10b-5 for over fifty years, since the Commission first promulgated Rule 10b-5, and its interpretation is consistent with the critical role of stockbrokers in the securities markets and the trust and reliance that customers place in them. See, *e.g.*, *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947).

The Commission's interpretation follows directly from the text of Section 10(b) and Rule 10b-5. Section 10(b) prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the Commission "in the public interest or for the protection of investors." 15 U.S.C. 78j(b). Rule 10b-5 in turn prohibits "any person" from "employ[ing] any device, scheme, or artifice to defraud," "mak[ing] any untrue [or misleading] statement of a material fact," or "engag[ing] in any act [or] practice"

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[2] Because the court of appeals, rather than merely reversing the district court's grant of summary judgment, dismissed the Commission's complaint for failure to state a claim, this Court must assume that the allegations in the complaint are true and can affirm the dismissal only if the Commission could prove no set of facts that would entitle it to relief. See *Hartford Fire Ins. Co.* v. *California*, 509 U.S. 764, 811 (1993).

that "operates or would operate as a fraud or deceit upon any person" "in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5. In short, Section 10(b) and Rule 10b-5 encompass "(1) using any deceptive device (2) in connection with the purchase or sale of securities." *United States* v. *O'Hagan*, 521 U.S. 642, 651 (1997).

A stockbroker's fraudulent sales of his customer's securities and fraudulent conversion of the proceeds satisfy both of those elements. Feigning loyalty to one's principal while secretly converting the principal's property to one's own use is a well recognized form of fraud. See *O'Hagan*, 521 U.S. at 655-656; *Carpenter* v. *United States*, 484 U.S. 19, 27 (1987). Thus, a stockbroker commits a fraud against his customers both when he secretly sells his customers' securities for his own benefit rather than for theirs, and when, while continuing his pretense of investing funds as a loyal agent and fiduciary, he embezzles the proceeds from the sales, rather than preserving his fiduciary's property.

Both the fraudulent sales of the securities and the fraudulent misappropriation of the proceeds of the sales satisfy Section 10(b)'s requirement that the fraud or deception be "in connection with the purchase or sale of any security." See *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 9-13 (1971); *O'Hagan*, 521 U.S. at 655-656. The frauds and the sales are part of the same scheme. With respect to the fraudulent sales, it is self-evident that, when a sale is itself fraudulent, the fraud is committed in connection with the sale: the wrongful sale constitutes and consummates the fraud. As regards the misappropriation of the proceeds, the sales are the means by which the stockbroker generates the cash that he intends to embezzle. Moreover, in both

cases, the stockbroker's deception directly furthers his ability to make the sales because it deprives the customers of information that could prompt them to act to prevent the sales. Finally, the stockbroker has access to the customers' assets in the first place only because they have entrusted them to him so that he can purchase and sell securities.

Interpreting the federal securities laws to prohibit this type of fundamental fraud on investors also serves the broader purposes of those laws. A principal purpose of the securities laws is "to insure honest securities markets and thereby promote investor confidence." *O'Hagan*, 521 U.S. at 658. Ensuring that stockbrokers adhere to basic standards of honesty in their dealings with customer assets is critical to that goal. Preventing stockbrokers from misappropriating customer securities and their proceeds also furthers the closely related purpose of the securities laws to protect investors from fraud. See *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979); 15 U.S.C. 78j(b). There would be a serious gap in investor protection if stockbrokers could engage in fraud against their customers that is so central to the securities trading process without violating the securities laws, which are designed to regulate the entire trading process. See 15 U.S.C. 78b. Moreover, permitting deception as basic as a stockbroker's feigning loyalty to his customer, while actually converting the customer's securities to his own purposes and misappropriating the proceeds of the securities sales, would create a significant hole in the full-disclosure regime on which the securities laws are based. See *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 477 (1977).

Decisions of this Court and other precedent confirm that violations of Section 10(b) and Rule 10b-5 may be based on fraudulent sales of securities and misappro-

priation of the proceeds of securities sales. Most notably, in *Bankers Life*, this Court held that a complaint that alleged the fraudulent misappropriation of the proceeds of a securities sale stated a cause of action under Section 10(b). 404 U.S. at 9-13. See also, *e.g.*, *United States* v. *Kendrick*, 692 F.2d 1262 (9th Cir. 1982); 7 L. Loss & J. Seligman, *Securities Regulation* 3530 & n.189 (3d ed. 1991). Because the Commission has consistently interpreted the statute and the rule to prohibit fraudulent sales of securities and misappropriation of sales proceeds, an interpretation which it has articulated in the exercise of its adjudicatory authority since shortly after the rule was first promulgated, the Commission's interpretation is entitled to deference from the courts. See *United States* v. *Mead Corp.*, 121 S. Ct. 2164, 2171-2172 (2001); *Thomas Jefferson Univ.* v. *Shalala*, 512 U.S. 504, 512 (1994); *Davis* v. *United States*, 495 U.S. 472, 484 (1990).

The court of appeals erred in rejecting the SEC's interpretation based on the court's view that Section 10(b) and Rule 10b-5 prohibit only misrepresentations about particular securities and their attributes. Such a limitation is unsupported by the text of the statute and rule, is inconsistent with precedent, and would frustrate the purposes of the securities laws. See *O'Hagan*, 521 U.S. at 655-656; *Bankers Life*, 404 U.S. at 9-10. The court of appeals also erred in concluding that recognizing liability under Section 10(b) and Rule 10b-5 for fraudulent conversions of securities and embezzlement of securities proceeds would improperly federalize state law. Section 10(b) and Rule 10b-5 are properly understood to prohibit such conduct because it involves deception connected with securities transactions—the express concern of those federal provisions. See

O'Hagan, 521 U.S. at 655; cf. *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1093 n.6 (1991).

ARGUMENT

SECTION 10(b) AND RULE 10b-5 PROHIBIT A STOCKBROKER FROM FRAUDULENTLY SELLING HIS CUSTOMER'S SECURITIES FOR HIS OWN BENEFIT AND MISAPPROPRIATING THE PROCEEDS

Stockbrokers like respondent play a critical role in the investment marketplace. See D. Langevoort, *Fraud and Deception by Securities Professionals*, 61 Tex. L. Rev. 1247, 1280 (1983). They are intermediaries through whom information about the market and securities flows to individual investors. *Ibid.* & n.135; R. Pozen, *Financial Institutions: Cases, Materials and Problems on Investment Management* 175-185 (1978). The complexity of investment decision-making often requires reliance on their expertise. Langevoort, *supra*, at 1282. In addition, the stockbroker "is the person who actually trades securities for the investing public," and he "conducts himself and carries out his daily routine through the instrumentalities of the national securities exchanges and the over-the-counter market." *Rolf* v. *Blyth, Eastman Dillon & Co.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977), aff'd, 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978).

Even before the federal securities laws were enacted, state law recognized that a stockbroker generally acted as the customer's agent in executing the customer's orders for the purchase or sale of securities. C.H. Meyer, *The Law of Stockbrokers and Stock Exchanges* § 39, at 249 (1931). The law further recognized that the agency relationship between the stockbroker and customer was fiduciary in nature. *Id.* § 40, at 251.

Consequently, the stockbroker was required to act in the customer's interest and not for his own benefit, and "with the utmost good faith and integrity." *Id.* at 253.[3]

Because of the critical role that stockbrokers play in securities transactions and the special relationship between stockbrokers and investors, the federal securities laws impose extensive strictures on stockbroker conduct. See Langevoort, *supra*, at 1280 & n.135; A. Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 Cornell L. Rev. 869, 871, 876-881 (1972). "There is no identifiable segment of the securities industry whose ethical conduct is more crucial to the attainment of Congress' goals than the ethical conduct of broker-dealers." *Dirks* v. *SEC*, 681 F.2d 824, 841 (D.C. Cir. 1982), rev'd on other grounds, 463 U.S. 646 (1983).

Against that background, the Securities and Exchange Commission, since shortly after it promulgated Rule 10b-5 in 1942, has interpreted Section 10(b) and Rule 10b-5 to prohibit a stockbroker from fraudulently misappropriating customers' securities and the proceeds of their security sales. See, *e.g.*, *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947); *Southeastern Sec. Corp.*, 29 S.E.C. 609 (1949). That interpretation reflects the

[3] When a brokerage firm sells securities owned by the firm to a customer, the firm acts as a principal rather than an agent in the sale and would not necessarily be a fiduciary with respect to the sale. Although in this case respondent was acting as the Woods' agent, see p. 15, *infra*, the Commission and the courts have long recognized that, even when brokerage firms act as principals, they implicitly represent that they will deal with clients honestly and in accordance with trade custom. See 8 L. Loss & J. Seligman, *Securities Regulation* 3772-3777 (3d ed. 1991); *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434, 435-437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

"agency relationship" between stockbrokers and customers, the customers' implicit understanding that stockbrokers will execute their transactions "honestly and in accordance with trade custom," and the "fiduciary" relationship arising out of the "trust and confidence" that customers place in their stockbrokers. *Kenneth Leo Bauer*, 26 S.E.C. at 774, 776; *Southeastern Sec. Corp.*, 29 S.E.C. at 613-614. The court of appeals erred in failing to defer to the SEC's interpretation, which follows from the text of Section 10(b) and Rule 10b-5, promotes their underlying purposes, and finds support in substantial precedent.

A. A Stockbroker's Fraudulent Sale Of Customer Securities And His Misappropriation Of The Proceeds Fall Within Section 10(b)'s Coverage Of "Deceptive Devices" Employed "In Connection With" Securities Transactions

Section 10(b) prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the Commission "in the public interest or for the protection of investors." 15 U.S.C. 78j(b). Section 10(b) does not require that the deception take a particular form; it prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (quoting *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)); see *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972). Section 10(b) was framed as a "catch-all" provision to reach all "cunning devices" related to securities transactions. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202

(1976); accord *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983); *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174 (1994).

Rule 10b-5 in turn prohibits "any person" from "employ[ing] any device, scheme, or artifice to defraud," "mak[ing] any untrue [or misleading] statement of a material fact," or "engag[ing] in any act [or] practice" that "operates or would operate as a fraud or deceit upon any person" "in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5. Thus, Section 10(b) and Rule 10b-5 encompass "(1) using *any* deceptive device (2) in connection with the purchase or sale of securities." *United States* v. *O'Hagan*, 521 U.S. 642, 651 (1997) (emphasis added).

Both those elements are satisfied here. The Commission's complaint in this case alleges that respondent, without the Woods' knowledge or consent, issued checks to himself drawn on a mutual fund account held by the Woods, and that the funds to pay the checks were obtained through the sale of mutual fund shares in that account. Pet. App. 28a. The Commission further alleges that on several occasions respondent sold mutual fund shares or other securities owned by the Woods without their knowledge or consent and misappropriated the proceeds of the sales. *Id.* at 29a. See also *id.* at 41a-42a (Superseding Indictment) (making similar allegations). That course of conduct establishes both elements of a Section 10(b) violation—(1) fraud (2) in connection with the sale of securities.[4]

[4] In a private action under Section 10(b), the plaintiff must establish not only fraud in connection with a securities transaction but also other elements. In particular, a private plaintiff (but not the government) must establish reliance (or causation) and damages. *SEC* v. *Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993); *SEC* v. *Blavin*, 760 F.2d 706, 711 (6th Cir. 1985). A private plaintiff seeking damages must also establish standing under *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), as a purchaser or seller, and satisfy the pleading requirements of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737.

1. A stockbroker commits fraud when he secretly sells his customer's securities for his own benefit and when he misappropriates the proceeds of the sales

Although the court of appeals did not dispute that respondent's alleged conduct constituted fraud, understanding the nature of respondent's fraud is important in understanding how it was connected to securities sales. Respondent's conduct was fraudulent because he deceived the Woods by pretending to act as their loyal agent and fiduciary while, at the same time, he converted their assets to his own use. His fraudulent scheme involved two distinct fraudulent conversions of the Woods' property—the conversion of their securities by selling them for his own benefit rather than theirs, and the misappropriation of the proceeds of those security sales.

The Woods entrusted their assets to respondent for him to invest for their benefit in his discretion. See Pet. App. 2a; 27a-28a; see also 41a. Thus, respondent was their agent and fiduciary. See Pet. App. 14a (noting respondent's "fiduciary duty" to the Woods). As the Woods' agent and fiduciary, respondent owed them a duty of loyalty and had authority to use their assets solely for their benefit and not to enrich himself. See Restatement (Second) of Agency § 387 (1958); Restatement (Second) of Trusts § 170 (1959); see also

Restatement (Second) of Agency § 383 (duty to act only as authorized). Furthermore, respondent owed the Woods a duty to give them all information relevant to the affairs entrusted to him. See *id.* § 381.[5]

When, without disclosure to the Woods, respondent acted beyond the scope of his authority and in breach of his duty of loyalty, respondent committed fraud. As this Court explained in *O'Hagan*, "[a] fiduciary who [pretends] loyalty to his principal while secretly converting the principal's [property] for personal gain' * * * 'dupes' or 'defrauds' the principal." 521 U.S. at 653-654 (internal citation and quotation marks omitted) (second brackets added). The fiduciary's conduct constitutes embezzlement of the property entrusted to him, which has long been recognized as a form of fraud. See *Carpenter* v. *United States*, 484 U.S. 19, 27 (1987) ("The concept of 'fraud' includes the act of embezzlement, which is 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'") (quoting *Grin* v. *Shine*, 187 U.S. 181, 189 (1902)). See also *Grin*, 187 U.S. at 189 ("it is impossible for a person to embezzle the money of another without

[5] The existence of an agency and fiduciary relationship was particularly explicit in this case, because, as both the court of appeals (Pet. App. 10a) and respondent (Br. in Opp. 13) note, respondent had discretion to engage in securities transactions on behalf of the Woods for their benefit without their prior approval. See also 8 Tr. 33-34, *United States* v. *Zandford*, Crim. No. WN-94-0165 (D. Md. July 19, 1995) (respondent's testimony and evidence that he had a general power of attorney over the affairs of William Wood). "A relationship of this sort, involving such broad authority over the customer's property, is a fiduciary one of extreme delicacy." Meyer, *supra*, § 39, at 306. Even absent such discretionary authority, however, respondent, as a stockbroker, would have a duty to his customers to adhere to his implicit representation of honest dealing. See note 3, *supra*.

committing a fraud upon him"); *Moore* v. *United States*, 160 U.S. 268, 269 (1895) ("Embezzlement is the fraudulent appropriation of property by a person to whom such property has been intrusted."). Such "misappropriation is a 'garden variety' type of fraud" that is proscribed by Section 10(b). See *Bankers Life*, 404 U.S. at 11 n.7.

As in the case of the fraudulent misappropriation of confidential information at issue in *Carpenter* and *O'Hagan*, the deception entailed in a fiduciary's misappropriation of securities or securities proceeds is inherent, because the success of the scheme depends on the agent's lulling the principal into believing that the agent is trustworthy. "The actual deception that is practised is in the continued representation of the [agent] to the [principal] that he is honest and loyal to the [principal's] interests." *United States* v. *Procter & Gamble Co.*, 47 F. Supp. 676, 678 (D. Mass. 1942). The agent's fraud can be seen either as an omission of a material fact necessary in order to make other statements made not misleading, which is prohibited by Rule 10b-5(b), or as fraudulent conduct, which is prohibited by Rule 10b-5(a) ("any device, scheme, or artifice to defraud") and Rule 10b-5(c) ("any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person"). Deceptive acts, as well as deceptive statements and omissions, have long been understood to constitute fraud. See *Shushan* v. *United States*, 117 F.2d 110, 115 (5th Cir.) ("A scheme to get money unfairly by obtaining and then betraying the confidence of another * * * would be a scheme to defraud though no lies were told."), cert. denied, 313 U.S. 574 (1941). Section 10(b) and Rule 10b-5 therefore readily apply to the fraudulent sale by a stockbroker of customer securities with which he has been entrusted

and to the stockbroker's misappropriation of the sale proceeds. The stockbroker's conduct constitutes fraud because it violates the implicit representation that he will not convert the customer's property to his own use. Cf. *O'Hagan*, 521 U.S. at 654 (implicit promise not to misuse confidential information becomes a sham when agent does so without disclosure to his principal).

Indeed, respondent's alleged conduct involved two distinct fraudulent conversions of the Woods' assets. Respondent's sale of the Woods' securities for the undisclosed purpose of benefitting himself (by furthering his plan to misappropriate the proceeds) was a fraudulent conversion and embezzlement of the securities themselves. See Meyer, *supra*, § 136, at 552 (wrongful sale of customer's securities is a conversion); *Taussig* v. *Hart*, 58 N.Y. 425 (1874) (same); *Sherman* v. *State*, 124 Tex. Crim. 205, 208 (1933) (per curiam) (agent's sale of stock with intent to misappropriate proceeds constitutes embezzlement of the stock itself). That conduct constituted fraud independently of whether respondent ultimately misappropriated the proceeds. See *United States* v. *Dunn*, 268 U.S. 121, 131 (1925) (fiduciary's "exercise of his power of disposition for his own benefit without more" is fraud); *United States* v. *Rowe*, 56 F.2d 747, 749 (2d Cir. 1932) (L. Hand, J.) ("A man is none the less cheated out of his property, when he is induced to part with it by fraud, because he gets a quid pro quo of equal value."); Meyer, *supra*, § 136, at 554 (damages for wrongful sale of customer's securities are measured by highest market value of securities within reasonable time after customer learns of sale, less amount credited to customer as a result of sale); *id.* at 557 (in stating that rule, courts "assume that the customer has been credited with the proceeds of the sale"). In addition, respondent's misappropriation of the proceeds of the

securities sales, while he pretended to act as a loyal agent and fiduciary, was a fraudulent conversion of that money. See *Bankers Life*, 404 U.S. at 10 & n.7; Meyer, *supra*, § 40, at 252; see generally *Grin*, 187 U.S. at 189 (misappropriation of money entrusted to one's care by another is a fraud).

2. A stockbroker's conversion of customer securities by means of fraudulent sales and his misappropriation of the sales proceeds are "in connection with" the sales

Respondent's alleged conduct also satisfies the requirement of Section 10(b) and Rule 10b-5 that the fraud be "in connection with the purchase or sale of any security." By its plain terms, that language requires only that there be a nexus or relationship between the fraud and a securities transaction. See *Bankers Life*, 404 U.S. at 12 (paraphrasing "in connection with" as "touching"); *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 476 (1977) (quoting the "touching" language from *Bankers Life* with approval); *SEC* v. *Clark*, 915 F.2d 439, 449 (9th Cir. 1990) ("some nexus"); *Abrams* v. *Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 593 (7th Cir. 1984) ("some nexus but not necessarily a direct and close relationship"); *Brown* v. *Ivie*, 661 F.2d 62, 65 (5th Cir. 1981) ("a nexus"), cert. denied, 455 U.S. 990 (1982). The necessary connection exists "when the proscribed conduct and the sale are part of the same fraudulent scheme." *Alley* v. *Miramon*, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980) (Wisdom, J.). Both respondent's fraudulent conversion of the Woods' securities by selling them for his own benefit and his subsequent misappropriation of the proceeds satisfy that standard.

a. As regards the fraudulent conversion of the securities themselves, there can be no question that the

fraud was "in connection with" the sales, because the sales were themselves fraudulent vis-a-vis the Woods. The sales (for the undisclosed purpose of benefitting respondent) consummated the fraud because they constituted the breach of respondent's duty of loyalty to the Woods and the fraudulent conversion of their securities. The connection between that fraud and the securities transactions is thus inherent, like the connection between the fraudulent misappropriation of confidential information and the securities transactions involved in *O'Hagan*. O'Hagan committed fraud by stealing information entrusted to him by his employer, to which he owed a fiduciary duty, and secretly using the information for personal profit by trading in securities. The Court explained that the "in connection with" requirement was satisfied in that case because "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities." 521 U.S. at 656. In this case, as in *O'Hagan*, the "securities transaction and the breach of duty thus coincide." *Ibid.*

In some respects, respondent's fraud was even more closely connected to the purchase or sale of securities than O'Hagan's. First, unlike O'Hagan, respondent did not misappropriate information and then use that information to profit from securities sales; respondent misappropriated the securities themselves, and he did so by the very act of selling them. Second, respondent deceived the owners of the securities, who were parties to the securities sales that he transacted. O'Hagan, on the other hand, deceived the owner of the confidential information, who was neither the buyer nor the seller in O'Hagan's securities transactions. See *O'Hagan*, 521 U.S. at 656 (holding that, under the misappropriation

theory of insider trading, the securities transaction and the breach of duty to disclose coincide "*even though* the person or entity defrauded is not the other party to the [securities] trade" (emphasis added)). Because O'Hagan's fraud was "in connection with the purchase or sale" of securities, respondent's fraudulent sale of the Woods' securities necessarily also had the requisite connection.[6]

Respondent's fraudulent conversion of the securities was also connected to the sales because the sales were the "direct result" of his deception. *SEC* v. *Drysdale Sec. Corp.*, 785 F.2d 38, 42-43 (2d Cir.), cert. denied, 476 U.S. 1171 (1986). If a stockbroker who was selling his customer's securities for his own benefit disclosed his intentions and actions to his customer, his customer could take steps to prevent the sales. See Langevoort, *supra*, at 1282 n.148 (describing the deception in stockbroker conversion cases as the "nondisclosure of facts sufficient to allow the client to protect his own interests by legal action or business response"). Thus, respondent's deception directly furthered his ability to make the security sales.

b. The securities sales were also an integral part of respondent's fraudulent scheme to misappropriate the proceeds of the sales. The sales were the means by which respondent accomplished the goal of that scheme. The complaint alleges that checks that respondent issued to himself drawn on the Woods' mutual fund account triggered the sale of mutual fund shares in the

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[6] The court of appeals attempted to distinguish *O'Hagan* as limited to insider trading. See Pet. App. 11a. Nothing in *O'Hagan*, however, suggests that the Court's analysis of the "in connection with" requirement was limited to insider trading cases. And nothing in the phrase "in connection with" suggests that the phrase has a special meaning in that context.

account. Pet. App. 28a. The complaint further alleges that, on repeated occasions, respondent sold mutual fund shares or other securities belonging to the Woods, caused checks to be issued in the amount of the proceeds of the sales, and deposited those checks in accounts under his control. *Id.* at 29a. In those instances, as the complaint alleges (and the court of appeals assumed), the sales were the means by which respondent "generated" the cash that he embezzled. *Ibid.*; *id.* at 2a. Thus, the fraud (the embezzlement) was "in connection with" the sales.

Indeed, respondent's fraudulent concealment of his intention to misappropriate the proceeds directly furthered his ability to make the sales that were necessary to generate those proceeds. The allegations in the complaint (which must be assumed to be true at this stage of the case, see n.2, *supra*) show that respondent had that intention at the time he made the sales. In the case of the mutual fund sales, the sales were directly and automatically triggered by respondent's act of cashing checks that he had made out to himself and that were drawn on the mutual fund account. Pet. App. 28a; see also *id.* at 41a (alleging that respondent "caused checks to be issued against the securities positions of [the Woods] and made payable to [himself] thereby causing their securities to be liquidated"). In the case of the other securities sales, respondent repeatedly sold securities and deposited checks representing the corresponding amounts of the proceeds into his personal accounts. *Id.* at 29a. The repetitive nature of the sales and subsequent conversions demonstrates that respondent intended to misappropriate the proceeds at the time that he made the sales.

The court of appeals was incorrect when it suggested (Pet. App. 12a) that respondent's misappropriation of

the proceeds of the sales of the Woods' securities is comparable to the hypothetical discussed in the opinion in *O'Hagan* of someone who "defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities." *O'Hagan*, 521 U.S. at 656. The securities purchase in the hypothetical was neither necessary to nor part of the fraud. The perpetrator in the hypothetical could have used the proceeds of his fraudulent scheme to make any other purchase. In this case, in contrast, the securities transactions were integral to respondent's fraudulent scheme. Respondent could not have accomplished his fraud without the securities sales, which generated the cash that he misappropriated. Moreover, it is implicit in the hypothetical that the subsequent purchase of securities is the *only* securities transaction with which the fraud could be connected. The Court did not suggest that, if the funds embezzled were the proceeds of securities sales, the fraud could not be "in connection with" those sales.

c. There is a particularly strong connection between fraud and securities transactions when stockbrokers like respondent misappropriate securities and securities proceeds from brokerage accounts, because the very purpose of the stockbroker/customer relationship and of the brokerage account is to carry out purchases and sales of securities. The stockbroker is the critical intermediary between investors and the securities markets; it is he who "actually trades securities for the investing public." *Rolf*, 424 F. Supp. at 1036; see p. 11, *supra*. "Investors maintain * * * accounts with brokerage firms for the very purpose of trading in securities." *Angelastro* v. *Prudential-Bache Sec., Inc.*, 764 F.2d 939, 944 (3d Cir.), cert. denied, 474 U.S. 933 (1985); see also *Mihara* v. *Dean Witter & Co.*, 619 F.2d

814, 824 (9th Cir. 1980) (upholding, in a churning case, a jury instruction stating that "a broker's activities are of necessity connected with the purchase and sale of securities"); *Rolf*, 424 F. Supp. at 1036 (broker's "very employment is 'in connection with the purchase and sale of securities.'"). The stockbroker/customer relationship involves an implicit representation that the stockbroker will invest the customer's assets in securities, not convert them. See p. 18 & note 3, *supra*. The court of appeals was therefore incorrect in concluding that "[t]he misappropriated proceeds might as well have come from the unlawful sale of a car which the Woods had entrusted to [respondent's] care." Pet. App. 12a. The fact that the proceeds came from securities sales was not happenstance. Respondent had access to the Woods' assets *only because* they had entrusted those assets to him to engage in *securities transactions*. See *id.* at 2a. Thus, when respondent fraudulently misappropriated their securities and the proceeds of their securities sales, his fraud was necessarily connected to securities transactions.

B. Stockbroker Liability For Fraudulent Misappropriation Of Customer Securities And Their Proceeds Furthers Important Policies Of The Securities Laws

Interpreting Section 10(b) and Rule 10b-5 to prohibit stockbrokers from misappropriating their customer's securities and securities proceeds furthers the fundamental purposes of the federal securities laws. As this Court explained in *O'Hagan*, a principal purpose of those laws is "to insure honest securities markets and thereby promote investor confidence." 521 U.S. at 658. The securities laws seek to achieve those goals by promoting "a high standard of business ethics in the securities industry." *Basic Inc.* v. *Levinson*, 485 U.S.

224, 234 (1988); see *Herman & MacLean*, 459 U.S. at 388-389; *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979). Ensuring that stockbrokers adhere to basic standards of honesty in their dealings with customer assets is critical to that effort. As noted above, stockbrokers play a central role in enabling the participation of investors in the securities markets. Frauds by stockbrokers that impair customer assets erode investor confidence and undermine the operation of the markets.

A closely related purpose of the securities laws is to protect "[d]efrauded investors." *Herman & MacLean*, 459 U.S. at 390; see *Naftalin*, 441 U.S. at 775 ("[p]revention of frauds against investors was surely a key part" of Congress's program to regulate the securities industry); 15 U.S.C. 78j(b) (authorizing Commission to define the scope of Section 10(b) through rules "necessary or appropriate * * * for the protection of investors"). Fraudulent misappropriation of customer assets by stockbrokers is a serious and all-too-frequent form of fraud. There would be a significant gap in investor protection if stockbrokers could engage in that conduct without violating the securities laws. In fiscal year 2000 alone, the Commission brought 16 actions under Rule 10b-5 against stockbrokers for fraudulent conversion of customers' property, including securities and proceeds of sales of securities.[7]

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[7] See *David Barroso, Jr.*, Exchange Act Release No. 43,386, 73 SEC Docket 1396 (Sept. 29, 2000); *Douglas J. Hopwood*, Exchange Act Release No. 43,353, 73 SEC Docket 1125 (Sept. 26, 2000); *Cheryl A. Rodgers*, Exchange Act Release No. 43,351, 73 SEC Docket 1121 (Sept. 26, 2000); *SEC* v. *Christie*, Litigation Release No. 16,724, 73 SEC Docket 1348 (Sept. 26, 2000); *SEC* v. *Smith*, Litigation Release No. 16,698, 73 SEC Docket 910 (Sept. 12, 2000); *SEC* v. *Meridian Asset Mgmt., Inc.*, Litigation Release No. 16,638,

As the comprehensiveness of the Exchange Act makes clear, Congress intended to protect investors by regulating the *entire* securities trading process. Indeed, the Act expressly states that "transactions in securities * * * are affected with a national public interest" that makes it "necessary to provide for regulation and control of *such transactions and of practices and matters related thereto*," including the system for "settlement of securities transactions and the *safeguarding of securities and the funds related thereto*." See 15 U.S.C. 78b (emphasis added). Because the handling by stockbrokers of customer funds and securities is a critical part of the trading process, the Act "contains a number of provisions, in the nature of substantive regulation, that are designed to protect customers' funds and securities in the hands of broker-dealers." 7 L. Loss & J. Seligman, *Securities Regulation* 3107 (3d ed. 1991). It would make no sense to interpret Section 10(b), the "catch-all" antifraud provision in an act designed to regulate the entire securities trading process, including the handling by broker-dealers of customer assets, to

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72 SEC Docket 3064 (July 31, 2000); *Janney Montgomery Scott LLC*, Exchange Act Release No. 43,050, 72 SEC Docket 2663 (July 18, 2000); *Thomas V. Conwell*, Exchange Act Release No. 43,006, 72 SEC Docket 2500 (July 3, 2000); *Shan Michael Hefley*, Exchange Act Release No. 42,625, 72 SEC Docket 259 (Apr. 5, 2000); *SEC* v. *Hefley*, Litigation Release No. 16,479, 71 SEC Docket 2839 (Mar. 21, 2000); *Donald J. Martineau*, Exchange Act Release No. 42,422, 71 SEC Docket 1994 (Feb. 14, 2000); *SEC* v. *Conwell*, Litigation Release No. 16,420, 71 SEC Docket 1675 (Feb. 1, 2000); *SEC* v. *Martineau*, Litigation Release No. 16,406, 71 SEC Docket 1304 (Jan. 10, 2000); *SEC* v. *Sunpoint Sec., Inc.*, Litigation Release No. 16,366, 71 SEC Docket 464 (Nov. 19, 1999); *SEC* v. *Bulas*, Litigation Release No. 16,337, 70 SEC Docket 2887 (Oct. 15, 1999); *SEC* v. *Tropeano*, Litigation Release No. 16,327, 70 SEC Docket 2502 (Oct. 5, 1999).

exclude frauds about matters as potentially disruptive of that process as a stockbroker's scheme to misappropriate customer securities and securities proceeds.

Further, "the fundamental purpose of the 1934 Act 'to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*'" would also be eroded by the court of appeals' exclusion of respondent's fraud from the scope of Section 10(b). *Santa Fe*, 430 U.S. at 477 (citation omitted). Permitting deception on matters so central to securities transactions as those involved here—a stockbroker's feigning loyalty to his customer, while actually using the customer's securities for his own purposes and misappropriating the proceeds of the securities sales—would create a significant hole in the full disclosure regime.

Congress expressly stated in the Exchange Act itself that its intent in passing the Act, which includes Section 10(b), was to "make [securities] regulation and control reasonably complete and effective." *Herman & MacLean*, 459 U.S. at 386 (quoting 15 U.S.C. 78b). Interpreting Section 10(b) to prohibit the kinds of fraud involved in this case is critical to that goal because no other provision of the federal securities laws provides an equally effective alternative to police stockbrokers who fraudulently misappropriate customer property.[8] And the Commission's ability to take action against

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[8] Although Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), on which the Commission also relied below (see note 1, *supra*), prohibits fraud "in" the sale of securities, the conduct at issue here would not be prohibited by Section 17(a) if it is not covered by Section 10(b). See *United States* v. *Naftalin*, 441 U.S. at 773 n.4 (discussed at p. 41, *infra*). Section 15(c) of the Exchange Act, 15 U.S.C. 78*o*(c) (1994 & Supp. V 1999), prohibits brokers or dealers from engaging in fraudulent conduct only with respect to transactions in the over-the-counter market, not on exchanges.

stockbrokers absent a violation of the securities laws is limited.[9]

C. Precedent Supports Stockbroker Liability For Misappropriation of Customer Securities And Securities Proceeds

1. *This Court's decision in* Bankers Life *supports the conclusion that Section 10(b) and Rule 10b-5 are violated when a stockbroker fraudulently misappropriates customer securities and securities proceeds*

In *Bankers Life*, the Court held that a complaint that alleged the fraudulent misappropriation of the proceeds of a securities sale stated a cause of action under Section 10(b). The defendants in that case led a company's board of directors to believe that the company would receive the proceeds from a proposed sale of Treasury bonds, when in fact the defendants (who were corporate insiders and thus fiduciaries) intended to misappropriate the proceeds for their own use. 404 U.S. at 9. This Court reversed a decision of the Court of Appeals for the Second Circuit in which that court,

[9] Section 21(d)(1) of the Exchange Act, 15 U.S.C. 78u(d)(1), authorizes the Commission, in some circumstances, to bring an injunctive action based on a violation of the rules of a securities industry self-regulatory organization, such as the National Association of Securities Dealers. Section 21(f), 15 U.S.C. 78u(f), however, states that the Commission "shall not bring any action pursuant to subsection (d) * * * for violation of * * * the rules of a self-regulatory organization unless" the Commission finds that the self regulatory organization "is unable or unwilling to take appropriate action" or it is otherwise necessary or appropriate in the public interest for the Commission to bring such an action. The Commission also can bring administrative proceedings against brokerage firms and their personnel under Section 15(b)(4) and (6) and Section 21C of the Exchange Act, 15 U.S.C. 78o(b)(4) and (6), 78u-3, but only based on a violation of a provision of the securities laws, such as Section 10(b), or a criminal conviction.

much like the Fourth Circuit here, held that Section 10(b) did not apply to misappropriation of the proceeds of a sale of securities because "[t]here is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received." 430 F.2d at 360. This Court rejected that reasoning, holding that the "in connection with" requirement was satisfied when the board of directors was deceived about the reason for the sale of its securities, regardless of whether "the proceeds of the sale * * * were misappropriated." 404 U.S. at 10.

Although the Second Circuit in *Bankers Life* had acknowledged that, if the board had known that the defendants "intended to misappropriate the proceeds for their own use[,] it undoubtedly would not have authorized the sale," the court nonetheless held, like the Fourth Circuit in this case, that the fraud was not in connection with the sale of a security. 430 F.2d at 360. As the Fourth Circuit did here, the Second Circuit in *Bankers Life* reasoned that the "deception did not infect the subsequent sales transaction." *Ibid.* Compare Pet. App. 9a ("The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion."). This Court rejected that reasoning and held that, although "the full market price was paid for th[e] bonds," because the board had been "duped into believing that it * * * would receive the proceeds," "[w]e cannot agree * * * that the 'purity of the security transaction and the purity of the trading process were unsullied.'" 404 U.S. at 9-10.

The court of appeals in this case attempted to distinguish *Bankers Life* on the ground that, in that case, it was the defendants' misrepresentation, rather

than an omission, that induced the securities sale. Pet. App. 13a. That purported distinction does not withstand scrutiny. Although *Bankers Life* may have involved a misrepresentation rather than, as in this case, silence in the face of a duty to disclose, that distinction is of no legal significance. Omissions are treated the same as false statements under Section 10(b) and Rule 10b-5 as long as there is a duty to disclose the information. See *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980) ("silence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b)" when there is "a duty to disclose arising from a relationship of trust and confidence"); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972) (finding liability under Section 10(b) even though "these defendants may have made no positive representation or recommendation," because the "sellers had the right to know that the defendants were in a position to gain financially from their sales"). Moreover, as a practical matter, the only reason there was a misrepresentation in *Bankers Life* and an omission here is that the board needed to authorize the sale in *Bankers Life*, but the Woods had given respondent discretion to engage in securities transactions on their behalf. Accordingly, a rule that prohibited misrepresentations but not omissions would leave unprotected those brokerage customers most in need of the law's protection.

Because respondent had a fiduciary duty to the Woods, he also had a duty to disclose to them that he was selling the securities they had entrusted to him and using the proceeds for his own benefit. Further, as explained above, see p. 21, respondent's failure to disclose his plans and actions deprived the Woods of the opportunity to prevent the sales. Thus, respondent's

failure to disclose was instrumental to the sales in this case just as the misrepresentation in *Bankers Life* was instrumental to the sale in that case. Finally, the court of appeals' attempt to distinguish *Bankers Life* on the ground that respondent's deception was not "about a particular security" (Pet. App. 13a) is misplaced. The relationship between the deception and particular securities is no different here than in *Bankers Life*.[10] In any event, the scope of Section 10(b) is not restricted to misrepresentations about particular securities and their attributes. See pp. 39-43, *infra*.

Bankers Life also indicates that the fraudulent misappropriation of securities in connection with a securities transaction violates Section 10(b). In support of its holding in *Bankers Life*, this Court cited, 404 U.S. at 10-11 n.7, two lower court decisions that so held. In the first of those cases, *Allico Nat'l Corp.* v. *Amalgamated Meat Cutters of North America*, 397 F.2d 727 (7th Cir. 1968), the court of appeals "held sufficient under § 10(b) and Rule 10b-5 a complaint which charged that defendant union * * * breached a prior agreement to sell 100% of the stock in a wholly owned * * * company to plaintiffs." 404 U.S. at 10 n.7. As this Court explained, the court of appeals in *Allico* "placed primary reliance on the fact that * * * the union misappropriated some 25,000 shares of the * * * stock which had previously been sold to plaintiffs for

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[10] Although the deceptions in both this case and *Bankers Life* did not concern the *attributes* of particular securities, the deceptions in both this case and *Bankers Life* did concern *transactions* in particular securities. Respondent deceived the Woods with respect to each sale of their securities, because, with respect to each sale, he maintained the pretense that he was acting for their benefit rather than his own and that the proceeds would be used for their benefit rather than his benefit.

cash, but which were being held in escrow pending consummation of the agreement." *Ibid.* In the second of the two cases cited in the *Bankers Life* footnote, *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964), the district court held that "a conspiracy to loan plaintiff money to buy securities, followed by the misappropriation of the purchased securities when they were pledged to secure the loan, * * * violate[d] § 10(b) and Rule 10b-5." 404 U.S. at 11 n.7.

2. Other precedent supports stockbroker liability for fraudulently misappropriating customer securities and their proceeds

Several other courts of appeals have recognized that fraudulent conversion of securities and the proceeds of securities sales violates Section 10(b). For example, in *United States* v. *Kendrick*, 692 F.2d 1262 (1982), the Ninth Circuit held that a stockbroker who converted to his own use money that he obtained from customer margin accounts that were secured by the pledge of securities engaged in fraud in connection with the sale of securities. *Id.* at 1264-1266. The stockbroker in *Kendrick* wrote checks payable to himself on the margin accounts, and those transactions were recorded as loans to the customers secured by the pledged securities. *Id.* at 1264. After explaining that a pledge of securities to secure a loan is a sale of securities within the meaning of the securities laws, see *Rubin* v. *United States*, 449 U.S. 424, 431 (1981), the court held that a sale of securities occurred each time a check was issued, because the brokerage firm each time acquired an additional interest in the pledged securities. 692 F.2d at 1265. The court next explained that the stockbroker engaged in fraud because he "failed to disclose to his customers * * * that he was acting

beyond his authority in using customer funds for his own use." *Id.* at 1265-1266. Finally, the court concluded that the fraud was "in connection with" the sales because the stockbroker was engaged in the fraud at the time he caused the brokerage firm to issue the checks on the margin accounts, which was the time at which the sales occurred. *Ibid.*

Other courts of appeals have found Section 10(b) violations in similar circumstances. See *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1027-1029 (6th Cir. 1979) (brokerage firm's fraudulent conversion of bonds that customer had pledged to the firm as collateral violated Section 10(b)); *SEC* v. *Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1094-1095 (2d Cir. 1972) (Section 10(b) violated by "misappropriation of the proceeds" of an initial public offering by retaining funds paid by investors when the precondition for retaining the proceeds had not been met); *Richardson* v. *MacArthur*, 451 F.2d 35, 39 (10th Cir. 1971) (seller's scheme to defraud buyer by converting stock after the sale violates Section 10(b)); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.) (allegation that brokerage firm knew of and facilitated another stockbroker's scheme to convert the securities investment funds of its customers states a claim under Section 10(b)), cert. denied, 396 U.S. 838 (1969).[11]

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[11] The Second Circuit has held that a fiduciary's fraudulent conversion of stock several months or years after the stock is purchased is not "in connection with" the earlier purchase. See *Flickinger* v. *Harold C. Brown & Co.*, 947 F.2d 595 (1991); *Pross* v. *Katz*, 784 F.2d 455 (1986). Even if we assume, *arguendo*, that those decisions were correct, they differ significantly from this case because respondent's fraudulent conversion of the Woods' securities was consummated by their sale. See p. 20, *supra*. In any event,

The leading commentators also agree that Section 10(b) is violated by a stockbroker's fraudulent sale of a customer's securities or conversion of the proceeds of securities sales. See 7 L. Loss & J. Seligman, *Securities Regulation* 3530 & n.189 (3d ed. 1991); 5B A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 38.01[b], at 2- 55 (1996); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 67.02, at 3-760 to 3-761 (1999); *id.* § 213.02, at 9-187 to 9-192, 9-197 (2001); 4 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud*, § 15.07(215)(3), at 15:162 (2d ed. 2000). See also L. Lowenfels & A. Bromberg, *Rule 10b-5's "In Connection With": A Nexus for Securities Fraud*, 57 Business Lawyer 1, 16 (2001) (noting, in discussing this case, that "[i]t is hard to understand how [respondent's] activities did not constitute fraud 'in connection with' the sale of a security").

D. The SEC's Contemporaneous And Consistent Interpretation Of Section 10(b) And Rule 10b-5 Is Entitled To Deference

The SEC has interpreted Section 10(b) and Rule 10b-5 to prohibit the fraudulent misappropriation by

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the mere passage of time between the securities transaction and the misappropriation does not preclude Section 10(b) liability. See 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 4.7(574)(3), at 88.35 (2d ed. 2001) (necessary connection exists "if the plaintiff can trace the proceeds or show a plan to misappropriate conceived at or near the sale"). In *Hunt* v. *Robinson*, 852 F.2d 786, 787 (1988), the Fourth Circuit held that an alleged fraudulent stock transaction was not actionable under Section 10(b) because the claim amounted to "common law fraud." As discussed below, however, the fact that an alleged fraud in connection with a securities transaction is also redressable under state law does not preclude liability under Section 10(b). See pp. 46-48, *infra*.

broker-dealers and their employees of customer securities and the proceeds of securities sales since the Commission first promulgated Rule 10b-5 in 1942. As the Commission emphasized in its brief amicus curiae in *Bankers Life*, "almost since the Commission was established, application of the antifraud provisions of the Securities Act and the Securities Exchange Act to the misappropriation of investors' funds has been particularly prominent in its regulation of brokers and dealers registered with it." SEC Br. at 19-20. See also *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964) (discussed in *Bankers Life*, 404 U.S. at 11 n.7, and at p. 32, *supra*) ("such activity has been consistently viewed by the SEC as a violation of Section 10(b) and Rule 10b-5").[12]

For example, in *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947), the Commission found a violation of Rule 10b-5 because the firm misappropriated to its own use securities and the proceeds of the sales of securities that customers had entrusted to the firm with the understanding that they would be sold and the money transmitted to the customers, as well as money customers had entrusted to the firm for the purpose of purchasing securities. *Id.* at 773, 775. The Commission noted that the firm was acting as the agent of the customers. *Id.* at 774. It characterized the firm's conduct as "the crudest and most flagrant type of scheme to obtain customers' funds and securities under false

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[12] Even before the promulgation of Rule 10b-5, the Commission had interpreted Section 17(a) of the Securities Act of 1933 to prohibit such stockbroker fraud. See *SEC* v. *Lawson*, 24 F. Supp. 360 (D. Md. 1938); *Globe Sec. Co.*, 10 S.E.C. 1105, 1109, 1110 (1942). As noted above, Section 17(a) is not directly at issue here, and respondent's conduct would not be prohibited by Section 17(a) if it is not covered by Section 10(b). See notes 1, 8, *supra*.

pretenses." *Id.* at 776. And it held that the misappropriations "violated the implicit representation that [the firm] would either execute transactions honestly and in accordance with trade custom or return the customers' funds." *Ibid.*

Similarly, in *Southeastern Securities Corporation*, 29 S.E.C. 609 (1949), the Commission found a violation of Rule 10b-5 because the president and director of a brokerage firm sold a customer's securities without her knowledge or consent and converted the proceeds of the sale to his own use. *Id.* at 611-612. The Commission noted that the relationship between the stockbroker and the customer was founded on "trust and confidence" and that his "duty as a fiduciary was to exert his most diligent and conscientious efforts in her interests and to subordinate his own." *Id.* at 613-614. Although the stockbroker argued that his conduct was authorized because he had discretion over the customer's affairs by virtue of a general power of attorney, the Commission rejected that argument. *Id.* at 614. The Commission explained that, "[e]ven assuming the existence and validity of the alleged power of attorney, [the stockbroker's] use of [the customer's] money for his purely personal benefit would not be authorized by that instrument in the absence of a showing of full and specific disclosure to, and understanding and consent by," the customer. *Ibid.* The Commission therefore concluded that the stockbroker's "taking and sale of [the customer's] securities and his use of the proceeds constituted a willful abuse of his trust" and a violation of Section 10(b) and Rule 10b-5. *Ibid.*[13]

[13] See also, *e.g.*, *D.S. Waddy & Co.*, 30 S.E.C. 367 (1949); *Calvert Sec. Corp.*, 35 S.E.C. 141, 143 (1953); *Stuart F. Beck*, Exchange Act Release No. 19,916, 28 SEC Docket 303 (June 27, 1983); *SEC v. Faitos*, Litigation Release No. 12,786, 48 SEC Docket 528 (Feb. 27, 1991); *SEC* v. *Harris*, Litigation Release No. 16,954, 74 SEC Docket 2058 (Apr. 6, 2001).

The interpretation of Section 10(b) and Rule 10b-5 embodied in those and similar adjudicatory decisions by the SEC is entitled to deference. Section 10(b) is not self-executing, but rather provides that the use of deceptive devices in connection with securities transactions is unlawful when it is "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b). Thus, Congress did not itself attempt to catalogue all the deceptive and manipulative devices and practices prohibited under Section 10(b), but vested "broad discretionary powers in the [SEC]" to define that conduct. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 7 (1934). The SEC has exercised that broad authority by promulgating Rule 10b-5. See 17 C.F.R. 240.10b-5. The construction of Section 10(b) reflected in Rule 10b-5 "is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." See *United States* v. *Mead Corp.*, 121 S. Ct. 2164, 2171 (2001). The SEC's interpretation of Rule 10b-5 must in turn "be given controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Thomas Jefferson Univ.* v. *Shalala*, 512 U.S. 504, 512 (1994) (quotation marks omitted).

In addition to giving the Commission express authority to define the scope of Section 10(b) through rulemaking, Congress has authorized the SEC to interpret Section 10(b) and Rule 10b-5 through adjudication. The Exchange Act authorizes the Commission to determine through formal adjudication whether

brokers and dealers have willfully violated the federal securities laws and the rules and regulations promulgated thereunder. See 15 U.S.C. 78o(b)(4)(D) and (6)(A)(i). "It is fair to assume that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force." *Mead*, 121 S. Ct. at 2172. Thus, the SEC's reasonable interpretation of Section 10(b) and Rule 10b-5 "promulgated in the exercise of that authority" must be given effect by the courts. *Id.* at 2171, 2172. See generally *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-844 (1984).

Substantial deference to the Commission's interpretation would be warranted here even absent the delegations of authority in Section 10(b) and other provisions of the Exchange Act to issue interpretations having the force of law. As noted above, the Commission adopted its interpretation in the years immediately following the promulgation in 1942 of Rule 10b-5, and the Commission has consistently adhered to that interpretation since that time. Considerable weight is due "a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new." *Norwegian Nitrogen Prods. Co.* v. *United States*, 288 U.S. 294, 315 (1933). See, *e.g.*, *Good Samaritan Hosp.* v. *Shalala*, 508 U.S. 402, 414 (1993); *Davis* v. *United States*, 495 U.S. 472, 484 (1990); *Edward's Lessee* v. *Darby*, 25 U.S. (12 Wheat.) 206, 210 (1827). "Moreover, such a contemporaneous construction deserves special deference when it has remained consistent over a long period of time." *EEOC* v. *Assoc.*

Dry Goods Corp., 449 U.S. 590, 600 n.17 (1981); see *Davis*, 495 U.S. at 484. See also, *e.g.*, *Udall* v. *Tallman*, 380 U.S. 1, 15 (1965) (applying same principle to interpretation of regulation). There is no reason to depart now from the Commission's contemporaneous and longstanding interpretation of Section 10(b) and Rule 10b-5, which, as described above, is consistent with the text and purposes of those provisions, as well as this Court's precedent.

E. The Court Of Appeals Erred In Engrafting On Section 10(b) And Rule 10b-5 Limitations That Do Not Appear In Their Text

1. Section 10(b) and Rule 10b-5 are not limited to misrepresentations about particular securities or the value or other attributes of particular securities

The court of appeals erred in reasoning that respondent's fraud did not have the requisite connection to a securities transaction because respondent did not mislead "the Woods about the relative merits or value of particular securities" (Pet. App. 9a), his misrepresentations "did not make any reference to the attributes of a specific security" (*id.* at 10a), and they "were not about a particular security" (*id.* at 13a). As explained above, respondent deceived the Woods with respect to each sale of their securities. See p. 31 & note 10, *supra*. Moreover, Section 10(b) and Rule 10b-5 require only that fraud be "in connection with" a securities transaction. That language does not impose a limitation on the subject matter of the prohibited deception.

"Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the 'investment value' of securities, and, indeed, it is established that a

10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value.'" *A.T. Brod & Co.*, 375 F.2d at 396-397.[14] See *SEC* v. *Jakubowski*, 150 F.3d 675, 679-680 (1998) (Easterbrook, J.), cert. denied, 525 U.S. 1103 (1999). Thus, in *O'Hagan*, the misrepresentation was (like the misrepresentation in this case) the fiduciary's false profession of his intent to honor his duty of loyalty to his principal, 521 U.S. at 653-654. In *Bankers Life*, the misrepresentation was that the seller of the securities would receive the sales proceeds, which is also an implicit misrepresentation in this case. 404 U.S. at 9-10. In neither *O'Hagan* nor *Bankers Life* did the deception concern the value or other attributes of a particular security.

Similarly, in *Naftalin*, this Court held that the defendant's misrepresentation about his intention and ability to sell securities violated Section 17(a) of the Securities Act of 1933, which prohibits fraud "in the offer or sale of any securities." 15 U.S.C. 77q(a). The defendant falsely represented that he owned stock that he entered into a contract with a broker-dealer to sell; in fact, he did not own the stock, and he was unable to deliver it because the price rose before the settlement date. 441 U.S. at 770-771 . The Court's conclusion that a misrepresentation concerning the ability and intention to deliver stock can form the basis for liability under Section 17(a) is instructive with respect to the scope of Section 10(b), because Section 17(a)'s prohibition on

[14] The Court in *Bankers Life* discussed this aspect of *A.T. Brod & Co.*, noting with apparent approval that the Second Circuit had reversed the dismissal of the complaint even though "no fraud [was] alleged as to the investment value of the securities." 404 U.S. at 11 n.7 (quoting 375 F.2d at 396).

fraud "in the offer or sale of any securities" is analogous to Section 10(b)'s prohibition on fraud "in connection with the purchase or sale of securities." See *Herman & MacLean*, 459 U.S. at 383 (characterizing *Naftalin* as "applying § 17(a) of the 1933 Act to conduct also prohibited by § 10(b)"); *Naftalin*, 441 U.S. at 773 n.4 (suggesting that "in" and "in connection with" are coterminous); *Hochfelder*, 425 U.S. at 213 n.32 (noting substantial overlap between text of Rule 10b-5 and Section 17). The broad language of Section 10(b) and Rule 10b-5, like the broad language in Section 17(a), is "expansive enough to encompass the entire selling process" and "does not require that the fraud occur in any particular phase of the selling transaction." *Naftalin*, 441 U.S. at 773.

Consistent with the statutory and regulatory texts, as well as this Court's precedent, the courts of appeals also have frequently found the "in connection with" requirement satisfied in cases in which the misrepresentation did not concern the value or any other attribute of a particular security. See *Press* v. *Chemical Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) (broker-dealer's failure to disclose to a customer purchasing a Treasury note that funds from the maturing note would not be available on the maturity date); *Jakubowski*, 150 F.3d at 679 (purchaser's misrepresentation of his identity); *Angelastro* v. *Prudential-Bache Sec., Inc.*, 764 F.2d 939 (3d Cir.) (misrepresentations about the interest rates on a margin account), cert. denied, 474 U.S. 935 (1985); *Marbury Mgmt., Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.) (securities salesman's fraudulent representation that he was a licensed registered representative when he was only a trainee), cert. denied, 449 U.S. 1011 (1980); *Arrington* v. *Merrill Lynch, Pierce, Fenner & Smith*, 651 F.2d 615 (9th Cir.

1981) (misrepresentation of the risks of buying securities on margin in a declining market); *Fey* v. *Walston & Co.*, 493 F.2d 1036 (7th Cir. 1974) (churning of customer accounts).[15]

Congress's purposes in enacting a broad antifraud provision like Section 10(b) would be seriously undermined by a rule that Section 10(b) encompasses only misrepresentations about the value or another attribute of a particular security. Such an interpretation would remove from the statute's purview many pernicious forms of fraud. For example, it would call into question the misappropriation theory of insider trading upheld in *O'Hagan*. Moreover, it would exempt from Section 10(b)'s coverage many types of fraud perpetrated by stockbrokers against their customers, in addition to fraudulent misappropriation of customer securities and their proceeds. As indicated by the cases cited above, deceptive conduct by stockbrokers frequently includes churning customer accounts and other misrepresentations about the trading process. See, *e.g.*, *Angelastro*, 764 F.2d at 943 (relying on decisions including "fraud involving the [securities] trading process" as within "the scope of section 10(b) and Rule 10b-5" to conclude

[15] In *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984), on which the court of appeals in this case relied (Pet. App. 7a, 10a), the Second Circuit suggested that only misrepresentations about the securities involved in a particular transaction could be "in connection with the purchase or sale" of securities. See 726 F.2d at 943. In subsequent cases, however, the Second Circuit has made clear that the "in connection with" requirement does not place a subject matter limitation on the misrepresentations that are actionable under Section 10(b). See, *e.g.*, *Drysdale Sec. Corp.*, 785 F.2d at 42-43 (holding that a misrepresentation about the financial condition of the seller was actionable under Section 10(b) when "securities were transferred as a direct result of [the] misrepresentation").

that a stockbroker's misrepresentation of the interest rates on a margin account violates Section 10(b)); *Mihara*, 619 F.2d at 824 (rejecting contention that, in a churning case, fraud must be shown in connection with each trade). Exempting those frauds from Section 10(b)'s coverage would directly frustrate Congress's intent to protect investors, achieve the highest standard of honesty in the securities industry, and safeguard securities and funds related to securities transactions. See pp. 24-27, *supra*. It would also be contrary to Congress's expressed concern in enacting the Exchange Act to remedy the "disregard of trust relationships by those whom the law should regard as fiduciaries" in the context of securities transactions. *Bankers Life*, 404 U.S. at 11-12 (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6 (1934)).

2. Applying Section 10(b) and Rule 10b-5 to a stockbroker's fraudulent conversion of customer securities and their proceeds would not improperly federalize state law

a. The court of appeals also erred in concluding that respondent's fraudulent sales of the Woods' securities and embezzlement of the proceeds of the sales constituted only conversion or theft, in violation of state law, and not securities fraud. See Pet. App. 12a, 14a. A stockbroker's embezzlement or fraudulent misappropriation of securities and their proceeds differs from simple conversion or theft, because the stockbroker's actions involve *fraud* or *deception* in connection with a securities transaction. See pp. 15-19, *supra*. Conversion or theft, in contrast, need not involve deception but only the taking of property belonging to another. See Restatement (Second) of Torts § 222A(1) (1977) ("Conversion is an intentional exercise of dominion or control

over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel."); *United States* v. *Corona-Sanchez*, 234 F.3d 449, 454 (9th Cir. 2000) (noting that "[t]he contemporary crime of 'theft' stems from the common law crime of larceny," which was "when one person misappropriated another's property by means of taking it from his possession without his consent"). Because Section 10(b) "trains on conduct involving manipulation or deception" "in connection with the purchase or sale of any security," a Section 10(b) action that is premised on deception does not improperly federalize state law. *O'Hagan*, 521 U.S. at 655.

In *O'Hagan*, the Court held that a fiduciary's misappropriation of his principal's confidential information is a violation of Section 10(b) when the fiduciary "feign[s] fidelity" to the principal. 521 U.S. at 655. As in *O'Hagan*, respondent here feigned fidelity to his principals while, at the same time, he misappropriated the property they had entrusted to him. See pp. 15-19, *supra*. Thus, like the conduct in *O'Hagan*, respondent's fraud falls squarely within the conduct prohibited by Section 10(b) and Rule 10b-5.

Other decisions of this Court confirm that situations that are generally the concern of state law also become the special concern of the federal securities laws when they involve deception connected with securities transactions. For example, in *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1090-1098 (1991), the Court held that misrepresentations about internal corporate affairs may be actionable under the federal securities laws when deception is involved, even though corporate mismanagement is generally governed by state law. In addition, in *The Wharf (Holdings) Limited* v. *United*

International Holdings, Inc., 121 S. Ct. 1776, 1782 (2001), the Court rejected the argument that a claim that a corporation sold an option contract with the secret intent not to honor the option was an "ordinary state breach-of-contract claim * * * outside the [Exchange] Act's basic objectives."

Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462 (1977), on which the court of appeals relied here (Pet. App. 14a), is not to the contrary. As this Court explained in *O'Hagan*, there was no deception in *Santa Fe*. See 521 U.S. at 655. *Santa Fe* involved a claim that the defendant majority shareholder, although it made full disclosure, breached its fiduciary duty to minority shareholders in a freeze-out merger. The Court ruled that that claim, standing alone, did not state a cause of action under Section 10(b). The primary basis for that holding was not that the case involved issues traditionally governed by state law, but that "the transaction, if carried out as alleged in the complaint, was neither deceptive nor manipulative." 430 U.S. at 474. The Court in *Santa Fe* pointed out the difference between the situation there, which involved only a breach of fiduciary duty by the majority shareholders, and cases "in which the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception." *Id.* at 474-475 & n.15 (citing, *inter alia*, *Bankers Life*).

In distinguishing *Santa Fe* in *Virginia Bankshares*, the Court explained that, although state law governs internal corporate affairs, Section 14(a) of the Exchange Act, which governs proxy solicitations, "does impose responsibility for false and misleading proxy statements." 501 U.S. at 1093 n.6. The Court further explained that, "[a]lthough a corporate transaction's 'fairness' is not, as such, a federal concern, a proxy statement's claim of fairness presupposes a factual integrity

that federal law is expressly concerned to preserve." *Ibid.* The same analysis applies to Section 10(b) actions involving conversion: Simple conversions of money and property, as such, are not the concern of Section 10(b). When those conversions involve deception in connection with a securities transaction, however, they become the concern of Section 10(b), because that provision is expressly designed to prohibit fraud connected with securities transactions.

b. When a stockbroker embezzles customer property, the customer likely has a state law claim for fraud as well as a claim under Section 10(b). The court of appeals erred, however, in suggesting that the existence of a fraud remedy under state law precludes liability under Section 10(b). See Pet. App. 8a, 14a. Section 10(b) and Rule 10b-5 contain no language excluding from their coverage frauds that are actionable under state law. In addition, Section 28(a) of the Exchange Act expressly provides that, with certain exceptions not relevant here, "[t]he rights and remedies provided by [the Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. 78bb(a) (Supp. V 1999).

More fundamentally, creating an exception from liability under Section 10(b) for common law fraud would eliminate Section 10(b) as a meaningful check on securities fraud, because most allegations of deception in connection with the purchase or sale of securities also support state law fraud claims. See *Madison Consultants* v. *FDIC*, 710 F.2d 57, 66 (2d Cir. 1983) (observing that if "Rule 10b-5 provide[d] relief only when state remedies are unavailable" it "would eviscerate the Rule" because state common law remedies permit recovery in most if not all areas covered by Rule 10b-5); 5A A. Jacobs, *Litigation and Practice Under*

Rule 10b-5, § 11.01, at 1-323 (1996) ("Common law and 10b-5 both provide relief for the same wrong—in other words, * * * that common law permits recovery will not bar a 10b-5 suit.").

Although the Court in *Santa Fe* expressed concern over the unwarranted encroachment of federal law into areas traditionally regulated by state law, that concern arose from the prospect of federal regulation *absent deceptive conduct*. See 430 U.S. at 478-479 (absent deception, federal action could "interfere" with or "overrid[e]" state law and policies). The Court recognized that "the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy." *Id.* at 478.

Thus, the Court has repeatedly found violations of Section 10(b) and Rule 10b-5 in cases in which there were also likely fraud remedies under state law. See *The Wharf (Holdings) Ltd.*, 121 S. Ct. at 1780; *O'Hagan*, 521 U.S. at 655; *Bankers Life*, 404 U.S. at 12. In those cases, as in this one, "[s]ince there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under [Section] 10(b), whatever might be available as a remedy under state law." *Ibid.*

Finally, it would make little sense to interpret the federal securities laws to cover highly technical fraudulent schemes that might not be reached by state common law but not to cover bold, straightforward fraudulent schemes long forbidden by state law. The primary federal role in regulating the national securities markets would be compromised by a regime that precluded the federal government from attacking the most outrageous and obvious frauds. See *SEC* v. Lauer, 52 F.3d 667, 670 (7th Cir. 1995) (Posner, J.) ("It

would be a considerable paradox if the worse the securities fraud, the less applicable the securities laws."). In 1947, the Commission recognized that schemes like respondent's are "the crudest and most flagrant type of scheme to obtain customers' funds and securities under false pretenses." *Kenneth Leo Bauer*, 26 S.E.C. at 776. Over 50 years later, that conduct still violates the federal securities laws.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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* The Solicitor General is recused in this case.

(8)

SUPREME COURT, U.S.
FILED
Feb 4, 2002
[redacted] 2002
CLERK

No. 01-147

IN THE

Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES ZANDFORD,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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QUESTION PRESENTED

Whether proof that a stockbroker liquidated positions in a discretionary investment account and then converted the proceeds to his own use, without more, establishes fraud "in connection with" a sale of securities within the meaning of § 10(b) of the Securities Exchange Act of 1934.

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STATUTE AND RULE INVOLVED

All sections herein refer to the Securities Exchange Act of 1934 (the Act), 15 U.S.C. § 78a *et seq.*, unless otherwise noted. The texts of § 10(b) and Rule 10b-5 are reproduced in the appendix to the petition for a writ of certiorari. Pet. App. 52a-53a. The texts of §§ 2, 9(a), 15(b) and (c), 15A(b), 19(b) and (c), and 21(d), (e) and (f) are reproduced in relevant part in the appendix. Resp. App. 1a-16a.

STATEMENT

This case requires this Court to determine whether a stockbroker's conversion of money, including proceeds from the sales of securities in a client's discretionary investment account, violates § 10(b) and Rule 10b-5. The parties agree that the outcome turns on the proper interpretation of § 10(b)'s requirement that a deception be "in connection with" a securities transaction. This case arises in the following setting:

1. In January 1991, the National Association of Security Dealers (NASD), "pursuant to its self-regulatory duties," conducted "a routine examination" of Dominick & Dominick, a brokerage firm located in Bethesda, Maryland. Pet. App. 34a.[1] The NASD "inadvertently discovered" that money had been transferred on more than twenty-six separate occasions from an investment account of William Wood and his daughter Diane Okstulski (the Woods) to accounts controlled by Charles Zandford or held in Zandford's name. Pet. App. 34a. The Woods set up the account with Zandford as their broker in November 1987. By March of 1988, they had committed funds totaling

[1] The facts summarized here are taken from the opinion of the court of appeals affirming Zandford's wire fraud conviction and the superseding indictment, upon which the SEC relied when it moved for summary judgment.

$419,255 to the account. Pet. App. 41a. By September 28, 1990, Zandford had caused the balance in the account to be depleted. Pet. App. 41a. When confronted about the transfers in early 1992, Zandford acknowledged that the money had been transferred to him. He explained that the money was transferred pursuant to three agreements he had entered into with the Woods in 1988 and 1989—a personal services agreement, an agreement to invest in a business, and an unsecured personal loan. Pet. App. 34a.

In April 1995, a federal grand jury in the United States District Court for the District of Maryland indicted Zandford, charging him with thirteen counts of wire fraud in violation of 18 U.S.C. § 1343. Pet. App. 35a. The indictment alleged that Zandford "caused checks to be issued against the security positions of [the Woods]" and "sold securities in [the Woods'] joint investment account . . . and then made personal use of the money." Pet. App. 41a-42a. Each of the thirteen counts of the indictment charged Zandford with causing a wire transfer to be made between Maryland and New York in executing the scheme. Pet. App. 40a-50a. With the exception of a reference in the indictment to the purchase of shares in the Colonel Tax-Exempt Insured Mutual Fund, Pet. App. 42a, the record does not establish what securities were bought or sold at any time.[2]

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[2] Based on allegations in its civil complaint, the SEC refers to sales of mutual fund shares from a mutual fund account. Pet. Br. 14. This allegation and others in the complaint were not alleged in the criminal wire fraud indictment and were not relied on by the SEC when it moved for summary judgment. The SEC contends that, because the court of appeals dismissed the case outright, this Court should review the entire record, not just the summary judgment papers, to determine whether the SEC established a § 10(b) violation. Pet. Br. 7 n.2. Respondent has taken the position that the record under review is the summary judgment record and the question is whether that record, viewed in the light most favorable to the SEC, states a § 10(b) violation. Br. in Opp. 10-12.

Zandford was convicted by a jury on all counts, sentenced to fifty-two months in prison, and ordered to pay $10,800 in restitution. Pet. App. 2a. On appeal, he argued, among other things, that there was insufficient evidence of a scheme to defraud because the Woods had voluntarily transferred their money to him via the three lawfully executed agreements. Pet. App. 36a-37a. In addressing the sufficiency of the evidence to convict, the court concluded that it was sufficient for the government "to cast doubt upon the validity of the agreements or demonstrate that the agreements themselves manifested the scheme by which Zandford tried to 'legitimize' the wholesale theft of the Woods' money." Pet. App. 36a. The court pointed to various factors, including the Woods' mental and physical limitations, the transfer of large sums of money from the investment account to Zandford's own accounts, the fact that the fraudulent agreements were contrary to the Woods' conservative investment objectives, and the fact that the agreements violated the rules of NASD and Zandford's employer. Pet. App. 36a-37a.

2. In September of 1995, the SEC filed the civil complaint in this action under § 10(b) of the Act and Rule 10b-5 and § 17(a) of the Securities Act of 1933. Pet. App. 25a.

In April of 1998, the SEC moved for partial summary judgment based exclusively on collateral estoppel. Pet. App. 3a, 16a-17a. It asserted that the facts established by the criminal judgment also established civil securities fraud and that Zandford was estopped from contesting those facts. Zandford moved to conduct limited discovery on the issue

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The court of appeals's decision makes clear that the court considered only the investment account. Pet. App. 14a. At this juncture, however, this dispute between the parties is inconsequential because the reference to the mutual funds is not critical to the analysis.

of whether his fraud was "in connection with" a securities transaction. Pet. App. 3a.

On March 2, 1999, the district court denied Zandford's discovery request and granted the SEC's motion for partial summary judgment.[3] Pet. App. 3a, 17a-18a. The district court granted summary judgment because it believed that Zandford's "criminal conviction was based on the same facts alleged by the Commission against Zandford . . . and that Zandford is therefore collaterally estopped from relitigating the facts underlying his conviction." Pet. App. 22a; Pet. App. 16a-17a.

3. The court of appeals reversed and held that collateral estoppel did not bar relitigation of any issue of law because Zandford's conviction for wire fraud did not require a determination of whether his "fraud was sufficiently connected to a securities transaction." Pet. App. 5a. That ruling is not contested here.

In the next portion of its opinion, relevant to the issue now before this Court, the court of appeals reviewed the district court's legal conclusion that "in this case," Zandford's sales of "securities as part of a scheme to misappropriate proceeds . . . satisf[y] the 'in connection with' requirement." Pet. App. 5a.

The court of appeals preliminarily observed that "[t]he federal securities laws do not cover all types of fraud.

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[3] The SEC had reserved from the motion for partial summary judgment the claims of excessive trading, or churning, which it acknowledged were not addressed by the criminal conviction and thus could not be resolved by invoking collateral estoppel. Opp. App. 16a n.1. The SEC later made clear to the court of appeals that, because it was "unlikely to receive any further relief by pursuing its excessive trading claims, the Commission has no intention of taking any further action against Zandford. Consequently, the Commission did not question the district court's decision to enter final judgment even though the Commission moved for partial summary judgment." Opp. App. 9a n.2.

Rather, both the Securities Act and the Exchange Act require that the defendant's fraud be connected to a securities transaction." Pet. App. 6a. The court noted that "[t]he precise contours of the in connection with requirement are not self-evident. . . . While the in connection with requirement must be flexible, it is not so elastic as to cover incidents which bear no relationship to market integrity or investor understanding." Pet. App. 7a.

Within this context, the court of appeals held that the federal securities laws do not extend to Zandford's fraudulent activities and that the "only connection with federal securities laws is that the funds were converted from a securities investment account." Pet. App. 14a (internal quotation marks and citation omitted); Pet. App. 7a-8a. The court held that the SEC had not alleged that "Zandford's inducements influenced any investment decision by the Woods other than to initially open their brokerage account." Pet. App. 9a. Dismissing the SEC's arguments concerning misappropriation and the applicability of *United States v. O'Hagan*, 521 U.S. 642 (1997), the court of appeals held that the only issue was "whether Zandford engaged in manipulation of a particular security," and held that he had not. Pet. App. 12a. Though it recognized that the conduct in question was "reprehensible," the court of appeals noted that Zandford "was criminally convicted and he doubtless faces other forms of civil liability and professional sanctions." Pet. App. 13a.

The court then concluded that, "while Zandford breached a fiduciary duty to the Woods, the Supreme Court has emphasized that the federal securities laws are not an open-ended breach of fiduciary duty ban." Pet. App. 14a. Accordingly, the court of appeals concluded that the SEC was not entitled to summary judgment and also directed that the case be dismissed. Pet. App. 14a.

SUMMARY OF ARGUMENT

The SEC urges this Court to conclude that § 10(b) and Rule 10b-5 are violated whenever a broker converts proceeds from the sales of securities in a client's account. However, § 10(b) prohibits only those types of fraud shown to be "in connection with the purchase or sale of any security." The court of appeals conducted the case-by-case analysis required by the language of § 10(b) and correctly held that neither Zandford's fraudulent scheme nor the conversion of the proceeds of securities sales established that the fraud was in connection with a sale of securities.

The plain language of § 10(b) limits the provision's application to manipulative or deceptive devices used "in connection with" a securities transaction. However, "manipulation or deception in connection with a securities transaction" means something different from "a securities transaction in connection with manipulation or deception." By excluding "a broader field involving any type of common law fraud in which a security was involved," this language "serves a useful filtration function." 8 Louis Loss & Joel Seligman, *Securities Regulation* 3686 (3d ed. 1991). The SEC urges this Court largely to eliminate that function by construing the phrase to encompass *any* nexus between deceptive devices and securities transactions.

Congress provided for a limited departure from its scheme of industry self-regulation by creating a catch-all for the use, by any person, of new manipulative and deceptive devices that corrupt the integrity of the market or influence investor understanding. Section 10(b) should be interpreted flexibly only to achieve those purposes.

Consistent with the limited purposes of § 10(b), the court of appeals properly held that evidence of conversion of funds from a securities investment account does not by itself establish a violation of § 10(b). The court concluded that the fraud was not shown to be in connection with a securities transaction because the fraud did not undermine market integrity or affect investor understanding. This conclusion is

consistent with the tests used by the Second and Seventh Circuits.

The SEC contends that the result reached by the court of appeals cannot be squared with *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). *Bankers Life*, however, does not support the SEC's contention that a fiduciary's misappropriation of the proceeds of securities sales necessarily violates § 10(b). As the court of appeals recognized, in *Bankers Life*, the defendant made misrepresentations about a particular security that induced another party either to "purchase or sell [a] security," Pet. App. 13a, and the seller was "duped into believing that it . . . would receive the proceeds" of the sale. *Bankers Life*, 404 U.S. at 9. In contrast, the Woods made no investment decision relating to any specific security. Moreover, the SEC's any nexus test is not supported by this Court's use of the word "touching" to describe the "in connection with" requirement. As Judge Friendly's careful analysis of that language in *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984), makes clear, the "touching" language restates, but does not articulate a test for interpreting, the "in connection with" requirement of § 10(b).

Alternatively, the SEC attempts to connect Zandford's deception directly to the securities sales. The SEC relies on this Court's decision in *O'Hagan* for the proposition that a sale of a security by a fiduciary who is feigning loyalty at the time of the sale violates § 10(b). However, *O'Hagan*, which addressed the use of misappropriated information in an insider trading case, does not support the SEC's use of fiduciary principles here. Although this Court announced no general "in connection with" test in *O'Hagan*, several factors influenced its decision that O'Hagan's deception was in connection with a securities transaction: (1) O'Hagan's fraud was consummated by a securities transaction; (2) misappropriated information can ordinarily be capitalized on only through a securities transaction; and (3) O'Hagan

simultaneously violated his fiduciary duty and harmed members of the investing public. This Court was also concerned about the consequences of not finding O'Hagan liable under § 10(b) because insider trading implicates the core congressional purposes behind the Act. None of these factors or concerns is present here.

First, the SEC has not proved that Zandford's sales were wrongful. Zandford was authorized, by virtue of the discretionary nature of the account, to engage in securities transactions without specific authorization for each transaction. That Zandford was feigning loyalty at the time of the sales does not, without more, establish a § 10(b) violation. Second, while O'Hagan could profit from the misappropriated information only through a securities transaction, the court of appeals correctly recognized that, because Zandford had control of the Woods' money before any securities transactions took place, the securities sales were not an essential part of his scheme. Third, Zandford's fraud did not harm the investing public in the same way as O'Hagan's. Zandford's conduct, though fraudulent, is not the type of deception that Congress perceived as a threat to market integrity, nor does it affect investor confidence in anything other than a particular broker or brokerage house. Further, holding that there is no § 10(b) violation in this case will not create a regulatory gap. Zandford's fraud is covered by other laws and regulations. In contrast, O'Hagan's trading on nonpublic information is the type of activity that led to federal regulation of the investment markets.

Finally, the SEC contends that its interpretation that § 10(b) and Rule 10b-5 apply to broker conversions merits deference. Pet. Br. 34–35. Although the SEC has been expressly delegated rulemaking authority under § 10(b), its interpretation of the "in connection with" requirement is not entitled to deference. Indeed, although *O'Hagan* raised questions about the proper application of the "in connection with" requirement of § 10(b), the government did not

request, and this Court did not grant, *Chevron* deference to the SEC's interpretation of that language.

Moreover, even if this Court is willing to defer to the SEC on this point, there is no SEC adjudication applying § 10(b) that is worthy of deference. The SEC primarily relies on a series of its public announcements and this Court's holding in *United States v. Mead Corp.*, 533 U.S. 218, 121 S. Ct. 2164 (2001), that agency adjudications can be worthy of *Chevron* deference. However, the SEC materials are not analogous to the agency adjudications referred to in *Mead*, 121 S. Ct. at 2173 n.12, which are much like published court opinions. The *Mead* adjudications contain extensive legal analysis, including examination of the underlying statutory language and the elements of the statutory provision. The materials offered by the SEC here, which consist merely of factual summaries and conclusory claims that § 10(b) applies, simply do not deserve deference. Finally, even if *Chevron* analysis were appropriate here, the SEC's proposed interpretation, that § 10(b) is violated any time a broker misappropriates a client's funds or securities, should be rejected because it is an unreasonable interpretation of § 10(b).

ARGUMENT

I. SECTION 10(b) ADDRESSES SPECIFIC FORMS OF MARKET MANIPULATION AND DECEPTION BY ANY PERSON AND IS NOT A CATCH-ALL PROVISION FOR ALL INSTANCES OF BROKER MISCONDUCT

The SEC argues that all broker conversions of client funds or securities violate § 10(b). Pet. Br. 8. Underlying that interpretation is the assumption that, because Congress intended for the *Act* to provide for comprehensive regulation of the securities industry, Pet. Br. 26, Congress intended *§ 10(b)* to provide that comprehensive regulation. Pet. Br. 24-28 (referring interchangeably to the purposes of

the Act and the purposes of § 10(b)). Interpreting that single provision independently to effectuate all of the remedial purposes of Congress's complex and extensive scheme for regulation of the securities industry cannot withstand analysis for three reasons.[4]

First, both the language of § 10(b) and its relation to other provisions of the securities laws accord greater significance to § 10(b)'s "in connection with" requirement than the SEC would allow. Second, though Congress found it "necessary to *provide for* regulation" of all aspects of securities transactions, Pet. Br. 26 (emphasis added), the structure and legislative history of the Act establish that Congress intended to provide for regulation through industry self-regulation with SEC oversight. *See Silver v. New York Stock Exchange*, 373 U.S. 341, 352-53 (1963) (observing that "[t]he pattern of governmental entry [into securities regulation] was by no means one of total displacement of the exchanges' traditional process of self-regulation"). Congress intended § 10(b) to serve an important, but limited, purpose as a catch-all for manipulative and deceptive devices that corrupt specific sales or purchases. Third, the SEC's legitimate concern that stockbroker conversion of client assets "is a serious and all-too-frequent form of fraud" that should not escape regulation, Pet. Br. 25, does not support the conclusion that § 10(b) always covers this type of conduct. Stockbroker conversion of client funds or securities is already covered by numerous provisions of the securities laws, exchange and

[4] This "Court has also noted that generalized references to the remedial purposes of the securities laws will not justify reading a provision more broadly than its language and the statutory scheme reasonably permit." *Aaron v. SEC*, 446 U.S. 680, 695 (1980) (internal quotation marks omitted) (quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)).

NASD regulations, state civil and criminal laws, and federal criminal law.[5]

A. The Language Congress Used in § 10(b) Confirms that the Provision Serves an Important, but Limited, Purpose in the Regulation of Securities Fraud

In construing § 10(b) and Rule 10b-5, implementing § 10(b), this Court has "turn[ed] first to the language of § 10(b), for 'the starting point in every case involving construction of a statute is the language itself.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). In the language of § 10(b), the phrase "in connection with" specifies the manner in which a manipulative or deceptive practice must relate to a purchase or sale of any security in order to violate the provision or any rules adopted thereunder. Whether considered independently or in comparison with other statutory provisions, § 10(b)'s "in connection with" requirement cannot be read to reach conduct that is no more than broker conversion of client funds or securities.

1. *"In Connection With" Specifies a Close Relationship Requiring that a Fraud Pertain to a Securities Transaction, Not Vice Versa*

The SEC interprets the language of § 10(b) to require "only that there be a nexus or relationship between the fraud and a securities transaction" such that any broker conversion of client assets violates § 10(b). Pet. Br. 19. By its language, however, § 10(b) does not reach all manipulative or deceptive practices that involve a securities transaction.

[5] Indeed, the same conduct that forms the basis of this proceeding under § 10(b) has already led to Zandford's federal wire fraud conviction, for which he was sentenced to more than four years in prison and ordered to pay restitution. Pet. App. 2a.

Cf. TRW Inc. v. Andrews, 122 S. Ct. 441, 449 (2001) ("[A] statute ought . . . to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." (internal quotation marks and citations omitted)). The range of meanings of the phrase "in connection with" is limited to denoting a close link, designation of which is usually made by a simple preposition such as "in," "on," or "pertains to." *See* Bergen Evans & Cornelia Evans, *A Dictionary of Contemporary American Usage* 386-88 (1957). As a compound-prepositional periphrasis, *see* H.W. Fowler, *A Dictionary of Modern English Usage* 105 (2d ed. 1965), "in connection with" modifies the object that it precedes. Evans & Evans, *supra*, at 386-88. In § 10(b), "in connection with" precedes, and therefore modifies, "the purchase or sale of any security."

Thus, the rules of usage support the intuitive conclusion that "manipulation or deception in connection with a securities transaction" means something different from "a securities transaction in connection with manipulation or deception." *Cf.* Loss & Seligman, *supra*, at 3686 ("By limiting Rule 10b-5 claims to instances when fraud occurred in connection with a security purchase or sale, rather than a broader field involving any type of common law fraud in which a security was involved, the ["in connection with"] element serves a useful filtration function."). In adopting the former formulation, Congress required that a manipulative or deceptive practice be a part of a securities transaction—that the manipulation or deception be in or pertaining to the transaction. The statute focuses on deceptions that affect securities transactions, and not on every scheme in which securities transactions play an incidental part.

2. *Considered in Comparison with Other Statutory Provisions, § 10(b)'s Language Does Not Cover All Instances of Broker Conversion*

The need for a direct link between a fraud and a purchase or sale of securities is evident from a comparison of § 10(b) and its "in connection with" language to other provisions of the Act. Section 15(b), for example—unlike § 10(b)—deals specifically with brokers. In specifying grounds for revoking or suspending a broker's registration, § 15(b) distinguishes between a crime that "involves the *purchase or sale of any security*," § 15(b)(4)(B)(i) (emphasis added), and a crime that "involves the larceny, theft, . . . embezzlement, *fraudulent conversion*, or misappropriation of funds, or securities." § 15(b)(4)(B)(iii) (emphasis added); *see* Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 571, § 6(b) (amending § 15 to add four categories of felonies or misdemeanors for conviction of which the SEC may deny registration). Juxtaposition of these two subsections of § 15(b)(4)(B) indicates that Congress recognized that fraudulent conversion or misappropriation of securities is a different species of misconduct from fraud that involves the purchase or sale of securities.[6]

Furthermore, Congress has demonstrated its capability to explicitly give an agency the power to deal with all forms

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[6] A similar distinction can be found in the rules of the NASD. NASD Conduct Rule 2120 provides, in language similar to that of § 10(b), that "[n]o member shall effect any transaction in, or induce the purchase or sale of any security by means of any manipulative, deceptive or other fraudulent device or contrivance." National Association of Securities Dealers, Inc., NASD Manual (CCH) 4141 (2001). The rules address broker misuse of customer funds or securities in a separate provision devoted to fair dealing with customers, NASD Conduct Rule 2310-2(4)(A)(iv), NASD Manual, *supra*, at 4262, suggesting a recognition of the distinction between broker misconduct generally and transactional fraud in particular.

of broker fraud. It need not resort to the roundabout technique of deeming all broker fraud to be "in connection with" a securities transaction. Section 206 of the Investment Advisors Act of 1940 gives the SEC jurisdiction over fraud *by an investment advisor* against a client. Section 4o(1) of the Commodities Exchange Act (CEA) gives the Commodity Futures Trading Commission (CFTC) jurisdiction over fraud *by a commodities advisor* against a client, whereas § 4b(a) of the same statute gives the CFTC jurisdiction over fraud *in connection with* a commodities transaction. Transaction-oriented statutes like § 10(b) and CEA § 4b(a) differ from status-oriented statutes like CEA § 4o(1) and Investment Advisors Act § 206. The interpretation of the former statutes should not be distorted to focus on the defendant's status as a broker. *Cf. Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 15 (2d Cir. 1983) ("We find nothing in the language or legislative history of section 10(b) or rule 10b-5 to suggest that Congress intended to impose a *special duty of disclosure* on broker-dealers simply by virtue of their status as market professionals."), *cert. denied*, 465 U.S. 1025 (1984).

B. The Act Codifies Congress's Plan for Self-Regulation Combined with Government Oversight, in Which § 10(b) Plays a Limited Role

Section 10(b) is not a tool by which the SEC can seek to effectuate all of the broad purposes of the Act.[7] Congress

[7] Imputing all of the Act's purposes to § 10(b), the SEC suggests that, because Congress stated its intention to provide a system for "settlement of securities transactions and the *safeguarding of securities and the funds related thereto*," Congress intended § 10(b) to safeguard securities and related funds. Pet. Br. 26 (quoting § 2). Congress did create a system for safeguarding securities and related funds, but it did so through an array of provisions other than § 10(b). *See, e.g.*, § 7 (providing for regulation of margin and other extensions of credit for the purchase of securities); § 8(b) (prohibiting brokers from lending a customer's securities without the customer's written consent).

did not enact a statute providing direct governmental regulation of *all* aspects of the securities trading process. Rather, it opted primarily for a model of self-regulation with SEC oversight. At the same time, it recognized the need for direct government regulation of manipulative or deceptive practices that fundamentally impair market operations. *See* S. Rep. No. 73-1455, at 30 (1934) (*hereinafter* Fletcher Report), *reprinted in* 2 Fed. Bar Ass'n Sec. Law Comm., Fed. Sec. Laws Legislative History 1933-1982, at 1293 (1983).

The SEC overlooks an important congressional motive when it declares that "[a]s the comprehensiveness of the Act makes clear, Congress intended to protect investors by regulating the *entire* securities trading process." Pet. Br. 26. The structure of the Act demonstrates Congress's general preference for self-regulation of the securities industry, subject to SEC oversight. *See* S. Rep. No. 73-792, at 1-5, (1934), *reprinted in* 2 Fed. Bar Ass'n Sec. Law Comm., *supra*, at 708, 708-12. By situating the primary responsibility for devising and enforcing regulations for broker conduct in the exchanges and over-the-counter securities associations,[8] the overall statutory scheme makes clear that Congress intended to protect investors by requiring the *industry* to regulate the *entire* securities trading process. Recognizing Congress's intent, this Court, in *Silver*, detailed the securities laws' approach to industry regulation:

> Thus arose the federally mandated duty of self-policing by exchanges. Instead of giving the Commission the power to curb specific instances of abuse, the Act placed in the exchanges a duty to register with the Commission, § 5, and decreed that

[8] Congress vested self-regulatory authority in over-the-counter securities associations with the Maloney Act of 1938, Pub. L. No. 719, 52 Stat. 1070 (1938).

> registration could not be granted unless the exchange submitted copies of its rules, § 6(a)(3), and unless such rules were "just and adequate to insure fair dealing and to protect investors," § 6(d).

373 U.S. at 352 (citations omitted).

Congress did not provide for direct governmental regulation of all aspects of the securities industry. Instead, Congress provided for comprehensive regulation by self-regulatory organizations (SROs), such as the New York Stock Exchange or the NASD,[9] with SEC oversight.[10] *See* S. Rep. No. 73-792, *supra*, at 13, at 720 (stressing that "the initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs remain with the exchanges themselves").

Since the adoption of the Act, Congress has expanded the SEC's authority over the SROs, but not by amending § 10(b), which has remained unchanged since its adoption in

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[9] Indeed, the NASD confirms that "it is undoubtedly true that NASD Regulation would have authority to bring disciplinary proceedings against Respondent for misappropriating his client's assets." NASD Br. 15. It contends, however, that its powers to "punish violations of NASD rules and the federal securities laws were designed to *complement* the Commission's enforcement authority, not to *substitute* for it." NASD Br. 15. The structure and purpose of the Act, however, demonstrate that the SEC's powers under the Act were designed to complement the SROs' enforcement authority, not the other way around. To the extent that the NASD, or any other SRO, finds its procedures inadequate to enforce its rules, it can amend those procedures, NASD Br. 17-18 n.9 (discussing proposed amendment to NASD rules to enhance NASD Regulation authority), and the SEC can bring an action to enforce those rules, § 21(d).

[10] The language of § 2, to which the SEC directs this Court's attention, confirms that Congress found it "necessary to *provide for* regulation" of all aspects of the securities industry. Pet. Br. 26 (emphasis added).

1934.[11] When Congress amended the Act in 1975 to give the SEC "plenary power over self-regulatory rules," S. Rep. No. 94-75, at 131 (1975), *reprinted in* 3 Fed. Bar Ass'n Sec. Law Comm., *supra*, at 2805, it did so by amending §§ 19(c) and 21(d) and (f). Under the amendments to § 21(d) and (f), the SEC can now bring an action for a violation of an SRO's rules if either the SRO is unable or unwilling to act, or the action is in the public interest or for the protection of investors. The Act provides, and Congress has enhanced, the means by which the SEC can fill gaps in self-regulation of the brokerage industry, but it does not do so through § 10(b). It would be anomalous to assume that Congress intended to give primary regulatory authority to exchanges, and to craft a well-defined role for the SEC in overseeing that authority, only to dispense with its entire design by empowering the SEC to regulate all fraudulent conduct by industry professionals directly through § 10(b).

Congress intended § 10(b) to serve as a "catch-all." *See Ernst & Ernst*, 425 U.S. at 201-03 (quoting *Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce*, 73d Cong. 115 (1934)); *see also Chiarella v. United States*, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catch-all clause to prevent fraudulent practices."). This Court has also noted, however, "that § 10(b) is not an all-purpose breach of fiduciary duty ban," *O'Hagan*, 521 U.S. at 655 (discussing *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977)), nor is it part of "a broad federal remedy

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[11] Congress has, in fact, consistently resisted SEC requests to expand § 10(b). For example, when, in 1957 and 1959, the SEC "sought from Congress amendment of § 10(b) to change its wording . . . to 'in connection with the purchase or sale of, or any attempt to purchase or sell, any security,'" Congress refused to extend § 10(b)'s reach. *Blue Chip Stamps*, 421 U.S. at 732. Though Congress refused to amend § 10(b) to cover attempted violations, it did amend the catch-all anti-fraud provision applicable to brokers in over-the-counter transactions, § 15(c)(1), to apply to attempts.

for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

The description of § 10(b) as a "catch-all" means only that Congress intended the provision to extend the Commission's authority to new manipulative or deceptive devices—to "any *other* cunning devices," *id.* (emphasis added)—of the sort that Congress had chosen to include in § 9. *See* Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 Va. L. Rev. 857, 859-60 (1984) (observing that § 10(b) is "designed to give the [SEC] the power to fill the inevitable omissions in the listing of manipulative devices in section 9"). "The extensive hearings that preceded passage of the 1934 Act touched only briefly on § 10, and most of the discussion was devoted to the enumerated devices that the Commission is empowered to proscribe under § 10(a)." *Ernst & Ernst*, 425 U.S. at 202. However, a spokesman for the drafters of § 9(c) of H.R. 7852, which would become § 10(b), described the purpose of the clause, explaining that "Subsection (c) says 'Thou shalt not devise any other cunning devices.'" *Hearings on H.R. 7852 and H.R. 8720*, *supra*, at 115 (1934) (testimony of Thomas G. Corcoran, spokesman for drafters). Corcoran described § 10(b) as "a catch-all clause to prevent manipulative devices . . . I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices." *Id.*

The Senate Report also discusses the types of new manipulative or deceptive practices—those that "might in some cases serve legitimate purposes"—that Congress intended the Commission to proscribe for the protection of investors or in the public interest and uses the examples of stabilization of security prices and grants of options. *See Ernst & Ernst*, 425 U.S. at 204-06; *see also* § 9(a)(6) (proscribing trades for the purpose of price stabilization in contravention of SEC rules). These practices directly implicate the concerns about manipulation corrupting the market that led Congress to make limited exceptions to its

self-regulation model when enacting §§ 9 and 10. *See* John E. Tracy & Alfred Brunson MacChesney, *The Securities Exchange Act of 1934*, 32 Mich. L. Rev. 1025, 1044 (1934). The Fletcher Report describes these concerns and the exchanges' inadequate response to these problems: "The true function of an exchange is to maintain an open market for securities, where supply and demand may freely meet at prices uninfluenced by manipulation and control. In the past this function has been fulfilled most imperfectly [by the exchanges]." Fletcher Report, *supra*, at 30.

Congress's use of different tools—self-regulation in some instances and direct proscription of defined practices in others—shows the flaw in the SEC's attempt to equate the purposes of § 10(b) with the broad purpose of pervasive securities industry regulation.[12] The court of appeals correctly applied a more discriminating approach and determined that § 10(b) was intended to protect market integrity and investor understanding. Pet. App. 7a. Brokers do play an important role in the securities industry, Pet. Br. 25, but given the focus of § 10(b) on the maintenance of market integrity in the face of new manipulative and deceptive devices, § 10(b) cannot be read to reach the entire

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[12] In its amicus brief in support of the SEC, the AARP adopts the flawed premise that the reach of the securities laws is delimited by the reach of § 10(b). AARP Br. 18-21. While protecting "frequent targets of fraud," AARP Br. 2, is a legitimate concern, the AARP erroneously presumes that § 10(b) is the only source of that protection. That presumption misconstrues the regulatory scheme and ignores the extensive remedies available to victims of broker misappropriation of assets without resort to § 10(b). Indeed, because § 10(b) is limited to intentional wrongdoing, *see Aaron*, 446 U.S. at 691, it cannot serve as the basis for perhaps the most effective remedy, imposition of civil liability on a brokerage house under a theory of respondeat superior.

range of broker misconduct that Congress intended for the SROs to regulate under SEC supervision.[13]

C. Recognition that § 10(b) Does Not Reach All Instances of Broker Conversion Does Not Leave a Gap in the Regulation of Brokers

The SEC may be correct that "[t]here would be a significant gap in investor protection if stockbrokers could" misappropriate customer assets without *any* corrective oversight under the securities laws, Pet. Br. 25, but it does not follow that a gap exists because a broker can engage in this type of conduct without violating *§ 10(b)*. Congress has equipped the SEC with a number of tools to oversee the operation of the SROs and to ensure that broker misconduct does not escape regulation, without resort to § 10(b). *See, e.g.*, § 6(b)(5) (authorizing the SEC to deny registration to an exchange the rules of which are not designed to prevent fraud and manipulation); § 15A(b)(6) (authorizing the SEC to deny registration to a national securities association the rules of which are not designed to prevent fraud and manipulation); § 19(b) (requiring SEC approval of proposed changes to SRO rules); § 21(d) and (f) (authorizing the SEC to bring actions to enforce SRO rules when the SRO is unwilling or unable, or SEC action is necessary for the public interest or protection of investors). The SEC's recognition of

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[13] Zandford's employer, Dominick & Dominick, is potentially subject to liability under other laws. Pet. App. 40a. Although that firm's liability was not raised here, Respondent did attempt to have the court of appeals take judicial notice of the fact that Diane Wood Okstulski filed a $2,620,000 lawsuit against Dominick & Dominick. *See Okstulski v. Dominick & Dominick*, 96-CV-604 (D. Md. filed Feb. 28, 1996). The SEC opposed the motion, and the court denied it on the same day that it announced its decision in the case. The point remains that victims of this type of fraud may seek redress from brokerage firms, regardless of whether the broker is liable under § 10(b).

this power—along with the other available remedies—dispels any concern that denying the SEC the authority to proceed under § 10(b) in this case would leave a gap in the regulation of brokers. Pet. Br. 28 n.9.

The type of conduct of which Zandford is accused would violate the rules of the NASD, *see* NASD Conduct Rule 2310, NASD Manual, *supra*, at 4261; NASD Br. 15, as well as the rules of every registered securities exchange. *See* § 6(b)(5) (requiring securities exchanges to have rules designed to prevent fraud and to maintain fair principles of trade). If the NASD is unwilling or unable to take appropriate action against Zandford for violation of its rules, the SEC has the authority to do so. *See* § 21(d). Similarly, if NASD enforcement of its rules fails to protect investors or serve the public interest, the SEC is authorized to enforce those rules directly, *see* § 21(f), or, if the rules themselves are inadequate, to prescribe new rules for the NASD, *see* § 19(c).

In the statutory scheme, SROs like the NASD represent the first line of defense against broker misconduct.[14] *See* S. Rep. No. 73-792, at 13 ("[T]he initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs remain with the exchanges themselves."), *quoted in Silver*, 373 U.S. at 352. As the NASD notes in its brief supporting the SEC, "it is undoubtedly true that NASD Regulation would have authority to bring disciplinary proceedings against respondent for misappropriating his client's assets." NASD Br. 15. Indeed, in accordance with the Act's requirement that SROs promulgate and enforce rules "designed to prevent

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[14] Ultimately, this type of fraud is best prevented by the SRO requirements that brokerage firms control the conduct of their employees. *See, e.g.*, NASD Rule 3010, NASD Manual, *supra*, at 4831-35. As the court of appeals noted in reviewing Zandford's wire fraud conviction, Zandford's conduct violated the rules of his employer, Dominick & Dominick. Pet. App. 37a.

fraudulent and manipulative practices, to promote just and equitable principles of trade," § 15A(b)(6); *accord* § 6(b)(5), the NASD holds brokers to exacting ethical standards.[15]

II. THE COURT OF APPEALS CORRECTLY HELD THAT CONVERSION OF THE PROCEEDS OF A SALE OF SECURITIES, WITHOUT MORE, DOES NOT VIOLATE § 10(b)

The court of appeals correctly concluded that "[t]he fact that Zandford's conduct as a broker may be within the scope of the securities statutes does not mean that his activities here necessarily constituted fraud in connection with a securities transaction." Pet. App. 14a. The court concluded that the fraudulent conversion of the proceeds of a sale of securities, without more in the record, does not constitute a violation of § 10(b). Pet. App. 14a. That conclusion is consistent with the interpretations of the "in connection with" requirement adopted by the Second and Seventh Circuits.

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[15] The NASD is the only national securities association currently registered under the Maloney Act. *See* Loss & Seligman, *supra*, at 227. The reach of NASD regulation is extensive, even though NASD's "internal disciplinary remedies are applicable only to NASD member firms and persons associated with them." NASD Br. 16. That the NASD cannot enforce its rules against non-members is irrelevant to a claim of a gap in the regulation of broker misconduct. A securities broker who does not join the NASD must belong to an exchange, *see* § 15(b)(8) (requiring that any broker who effects transactions other than on an exchange of which he or she is a member must belong to a registered securities association, *i.e.*, the NASD), and thus be subject to a similar set of rules overseen by the SEC. *See* §§ 6, 15. Further, a broker who fails to register faces a number of serious consequences, including injunction, § 21(d); civil penalty, § 21A; and criminal prosecution resulting in a fine of up to $1,000,000 and imprisonment for up to ten years, § 32(a).

A. Conversion of the Proceeds of a Sale of Securities Is Not Deception "In Connection With" a Securities Transaction

The court of appeals held that the conversion of the proceeds of securities sales is not fraud in connection with the sales of securities because it "bear[s] no relationship to market integrity or investor understanding." Pet. App. 7a. The SEC did not allege that Zandford's inducements influenced any investment decision by the Woods other than the initial decision to open a brokerage account and to entrust Zandford with the authority to invest their money at his discretion. The SEC did not claim that Zandford had to obtain the Woods' approval before trading securities. Pet. App. 10a. Further, it produced no evidence that the sales of securities in question were "conducted in anything other than a routine and customary fashion." Pet. App. 9a. Finally, the SEC expressly disavowed before the court of appeals any argument that the establishment of the discretionary investment account could itself be considered a security as defined by the securities laws. Brief for the SEC, *SEC v. Zandford*, 238 F.3d 539 (4th Cir. 2001) (No. 99-1733) at 31 n.16 ("Zandford also discusses whether opening an account is an investment contract. The Commission has not relied on such a theory in this case.").

Having determined that the SEC had only established that "funds were converted from a securities investment account," the court of appeals correctly concluded that this evidence was insufficient to establish a violation of § 10(b). Pet. App. 14a. That outcome is consistent with the tests used by courts in the Second and Seventh Circuits to determine whether a fraud is in connection with a securities transaction. The Second Circuit's longstanding interpretation of the "in connection with" requirement dates back to its oft-cited decision in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Building on that interpretation in *Chemical Bank*, Judge Friendly's opinion for the court addressed the question of

"whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a)"[16] of the Securities Act and § 10(b) of the Act. 726 F.2d at 943.[17] Judge Friendly answered that question in the negative, concluding that:

> The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.

Id.

Applying *Chemical Bank*, courts in the Second Circuit have held that conversion of the proceeds of sales of securities is not a violation of § 10(b).[18] *See Pross*, 784 F.2d at

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[16] Under § 17(a) of the Securities Act, the alleged fraud must be "in the offer or sale of any securities." Although "in the offer or sale" is arguably "narrower" than "in connection with the purchase or sale," this Court in *Bankers Life* "used the terms interchangeably." *United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979). At the petition stage, the SEC noted that it "d[id] not seek this Court's review . . . of the question whether the complaint [in this case] stated a claim under Section 17(a) because [the government had] not identified a square conflict between the decision of the court of appeals in this case and decisions of this Court or other courts of appeals on that question." Pet. Br. 4 n.1.

[17] In *Chemical Bank*, 726 F.2d at 943, Judge Friendly's opinion for the court answered the question this Court had left open with regard to § 17(a) of the Securities Act in *Rubin v. United States*, 449 U.S. 424, 429 n.6 (1981).

[18] The SEC contends that the *Chemical Bank* test has been modified by *SEC v. Drysdale Sec. Corp.*, 785 F.2d 38 (2d Cir.), *cert. denied*, 476

459 (Friendly, Oakes & Winter, JJ.) (holding that "conversion of property that happened to involve securities" did not violate § 10(b)); *see also Flickinger v. Harold C. Brown & Co.*, 947 F.2d 595, 598 (2d Cir. 1991) ("Section 10(b) is not violated by a fraudulent scheme that, some time after a purchase of securities, divests the purchaser of ownership."); *Bochicchio v. Smith Barney, Harris Upham & Co.*, 647 F. Supp. 1426, 1429-30 (S.D.N.Y. 1986) (holding that allegations that a broker with complete control over an account made unauthorized sales of securities and converted the proceeds did not state a § 10(b) claim). In the present case, the court of appeals applied the reasoning of the Second Circuit to conclude that the SEC had not alleged a § 10(b) violation. Pet. App. 7a-10a.

The result reached by the court of appeals is also consistent with decisions of the Seventh Circuit. That court generally holds that the "in connection with" requirement is satisfied only when allegedly fraudulent conduct

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U.S. 1171 (1986), to "ma[k]e clear that the 'in connection with' requirement does not place a subject matter limitation on the misrepresentations that are actionable under Section 10(b)." Pet. Br. 42 n.15. The SEC misreads *Drysdale*. Judge Winter's opinion for the Second Circuit does not depart from—rather, it follows—*Chemical Bank*'s legal principles. The court in *Drysdale*, quoting the same passage from *Chemical Bank* quoted in the text of this brief above, noted that, under *Chemical Bank*, "fraud pertaining to the consideration in a securities transaction is in connection with that transaction." *Drysdale Sec. Corp.*, 785 F.2d at 42. It held that that test was met because the allegedly misrepresented fact "was essential to the value received by the other party in a securities transaction." *Id.* Exactly one week after releasing Judge Winter's opinion for the court in *Drysdale*, the Second Circuit released Judge Winter's opinion for the court—joined by Judge Friendly—in *Pross v. Katz*, 784 F.2d 455 (2d Cir. 1986), which, as discussed in text, also reaffirms *Chemical Bank* and pointedly shows its relevance to this case.

"influences an investment decision"—the decision whether to purchase or sell a security. *SEC v. Jakubowski*, 150 F.3d 675, 680 (7th Cir. 1998) (Easterbrook, J.), *cert. denied*, 525 U.S. 1103 (1999). The Seventh Circuit has also held that deceptive practices by an agent exercising discretionary authority do not give rise to liability under § 10(b).[19] In a discretionary account, the principal does not make any investment decisions, and while there may be a breach of a fiduciary duty, there is no violation of § 10(b). *See O'Brien v. Cont'l Illinois Nat'l Bank & Trust Co.*, 593 F.2d 54, 60 (7th Cir. 1979) (Tone, J.) ("Here, however, that decision was not whether [the defendant] should buy or sell the securities in question [on the plaintiffs' behalf] . . . The decision to which the nondisclosure related was whether plaintiffs should terminate the trust or agency agreements or, perhaps, take some action against [the defendant]."); *see also Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co.*, 800 F.2d 177, 181 (7th Cir. 1986) (authority retained by client "relat[ed] to its relationship with [its broker], not to any particular decision to purchase or sell a security. The federal protection of section 10(b) and Rule 10b-5 does not govern this relationship."). The Seventh Circuit's reasoning applies to this case because the Woods established a discretionary account and, thereafter, made no investment decisions regarding any purchases or sales of securities.[20]

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[19] The SEC does not contest that Zandford had discretion to invest the Woods' assets. Pet. Br. 2.

[20] Congress has taken steps to protect owners of discretionary accounts under other provisions of the Act relating directly to brokers. *See, e.g.*, § 11(a)(1)(H) (requiring authorization from, and disclosures to, client for broker to exercise discretion); § 28(e)(2) (requiring brokers exercising investment discretion to make reports to the SEC according to SEC rules). In addition, several NASD Rules apply. *See* NASD Conduct Rule 2110, NASD Manual, *supra*, at 4112; NASD Conduct Rule IM-2310-2(b)(4)(A)(iv), NASD Manual, *supra*, at 4262; NASD Conduct Rule 2330(a), NASD Manual, *supra*, at 4291. Finally, state fiduciary and other common law rules apply. *O'Brien*, 593 F.2d at 60; Pet. App. 12a.

The SEC argues that this Court held in *Bankers Life* that "fraudulent misappropriation of the proceeds of a securities sale state[s] a cause of action under § 10(b)" and that *Bankers Life* therefore controls the outcome here. Pet. Br. 28.[21] *Bankers Life* does not stand for that proposition. In *Bankers Life*, the Second Circuit had held that, if the misrepresentation was not "[w]ith respect to the terms of the sale itself[,] neither the purchaser nor the seller of bonds was deceived or defrauded," and there was no violation of § 10(b). 430 F.2d 355, 360 (2d Cir. 1970). This Court disagreed and held that the seller was deceived because it "was duped into believing that it . . . would receive the proceeds" of the sale. 404 U.S. at 9.

What distinguishes *Bankers Life* from this case is that in *Bankers Life*, "the defendants made misrepresentations about a particular security that induced another party either to

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[21] The SEC also cites a number of lower federal courts for the proposition that § 10(b) is implicated by the conversion of securities and the proceeds of securities sales. Pet. Br. 32-33 (citing *United States v. Kendrick*, 692 F.2d 1262 (9th Cir. 1982), *cert. denied*, 461 U.S. 914 (1983); *Mansbach v. Prescott, Ball, & Turben*, 598 F.2d 1017, 1027-29 (6th Cir. 1979); *Richardson v. MacArthur*, 451 F.2d 35, 39 (10th Cir. 1971)). Those cases, like the only case cited by the SEC in the court of appeals for the proposition that § 10(b) applies to conversion, lack any substantial "analysis to support [their] holding[s]." Pet. App. 11a. (citing *Henricksen v. Henricksen*, 486 F. Supp. 622, 629 (E.D. Wis. 1980)). The SEC also cites two cases from the Second and Seventh Circuits. Pet. Br. 33 (citing *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1094-95 (2d Cir. 1972); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969)). Both of these cases predate the cases on which Respondent relies, and neither purports to depart from the tests developed in those circuits.

purchase or sell [a] security.". Pet. App. 13a.[22] As the SEC itself notes, the seller "needed to authorize the sale in *Bankers Life*" and was deceived into doing so. Pet. Br. 30. In contrast, the Woods were induced to part with money, *not* to purchase or sell any securities.[23] Zandford could buy or sell securities for the Woods' account without obtaining specific authorization for each transaction. Pet. Br. 30. He may have defrauded the Woods by taking their money in the first place, or by converting it later, but not by making the purchases and sales he was fully authorized to make.

The SEC correctly observes that this Court's opinion in *Bankers Life* did not rely on the fact that the defendants made an affirmative misrepresentation rather than omitting a material fact in the face of a duty to disclose. Pet. Br. 30

[22] The cases cited in *Bankers Life* do not support the proposition that a fraudulent misappropriation of securities necessarily violates § 10(b). *Contra* Pet. Br. 31 (citing 404 U.S. at 10 n.7 (citing *Allico Nat'l Corp. v. Amalgamated Meat Cutters*, 397 F.2d 727 (7th Cir. 1968); *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964))). As in *Bankers Life*, in each of these cases, the defrauded party was induced to purchase, pledge, or sell securities under the expectation that the defrauded party would receive something in return. *See Allico*, 397 F.2d at 730 (plaintiff induced to turn over 25,000 shares on expectation that union would fulfill contract); *Cooper*, 226 F. Supp. at 975 (plaintiff induced to pledge securities as collateral on expectation that shares would be returned upon repayment of loan). Because Zandford did not fraudulently induce the Woods to purchase, pledge, or sell securities, these cases are not relevant.

[23] The SEC cites to a recent article stating that the decision below "appears questionable." Lewis D. Lowenfels & Alan R. Bromberg, *Rule 10b-5's "In Connection With": A Nexus for Securities Fraud*, 57 Bus. Law. 1, 16 (2001). That opinion is apparently based in part on the premise that "[t]he broker obtained the client's securities by deception" and then sold the securities and stole the cash. *Id.* This premise, and the conclusion that follows, is faulty because Zandford did not obtain any securities by deception.

(arguing that Zandford's failure to disclose his disloyalty to his principals is the equivalent of the affirmative misrepresentation that was made in *Bankers Life*). Instead, this Court relied on the fact that "the seller was duped into believing that it, the seller, would receive the proceeds." *Bankers Life*, 404 U.S. at 9. Thus, the deception in *Bankers Life*, unlike Zandford's fraud, induced an investment decision.[24]

B. Contrary to the SEC's Claim, Showing Any Nexus Between a Deception and a Securities Transaction Does Not Satisfy the "In Connection With" Requirement of § 10(b)

The SEC asks this Court to conclude that the "in connection with" requirement is satisfied if there is *any* nexus between a fraud and a purchase or sale of securities. Pet Br. 19 (arguing that the language of § 10(b) requires "only that there be a nexus or relationship between the fraud and a securities transaction"). Under the SEC's test, because a sale of securities was incidentally involved in Zandford's scheme to convert the Woods' assets, his fraud would violate § 10(b). That test is not consistent with the language of § 10(b).

The SEC primarily relies on *Bankers Life* to support its proposed test. In *Bankers Life*, this Court concluded its opinion by stating that "[t]he crux of the present case is that

[24] For a similar reason, the SEC errs in asserting that the court of appeals's decision is in conflict with this Court's decisions in *Naftalin* and *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). Pet. Br. 40-41. As in *Bankers Life*, *Naftalin*'s fraud induced an investment decision, that of the broker to execute sell orders on the basis of representations by the client that he owned the stock. *Naftalin*, 441 U.S. at 770. In *Herman & MacLean*, this Court upheld § 10(b) liability when an investor's decision to purchase stock was made based on false information contained in a registration statement. 459 U.S. at 378, 382-83. Because the Woods made no similar investment decision, these decisions are inapposite.

[the seller] suffered an injury as a result of deceptive practices touching its sale of securities as an investor." 404 U.S. at 12-13. The SEC argues that, by using the word "touching" to describe the "in connection with" requirement, this Court in *Bankers Life* established that any nexus between a fraud and a securities transaction would suffice. Pet. Br. 19.

Subsequent interpretation makes clear that the SEC has read too much into the "touching" language. In *Chemical Bank*, 726 F.2d at 942-43, Judge Friendly, writing for the court, thoroughly analyzed the *Bankers Life* "touching" language, noting that other courts had initially decided that it articulated a new test but did not clearly identify its contours. *See, e.g., Mansbach*, 598 F.2d at 1027-28; *Brown v. Ivie*, 661 F.2d 62, 65 (5th Cir. 1981) (interpreting the "touching test" to require a nexus but not necessarily "'a direct or close relationship.'" (quoting *Alley v. Miramon*, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980))), *cert. denied*, 455 U.S. 990 (1982). However, the court concluded that: (1) the language was likely a paraphrase rather than an explication of the "in connection with" requirement; (2) the language was dicta; and (3) courts interpreting the language to require only a tenuous connection generally applied it in situations "where the connection was anything but tenuous."[25] *Chem. Bank*, 726 F.2d at 942. The opinion cited to the conclusion of a leading commentator in this area, which stated that "there is no reason to believe that [Justice Douglas's] use of 'touching' was anything more than his variation of 'in connection with' as a matter of literary style." *Id.* (internal quotations

[25] Many of the cases cited by the SEC are examples of this interpretation of *Bankers Life*. Pet. Br. 19. *See, e.g., Abrams v. Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 593 (7th Cir. 1984) (holding "in connection with" requirement 'easily satisfied' because defendants made fraudulent misrepresentations regarding value of securities at time of purchase and sale of security).

omitted) (quoting Louis Loss, *Fundamentals of Securities Regulation* 903-04 (1st ed. 1983)); *accord In re Ames Dept. Stores Inc. Stock Litig.*, 991 F.2d 953, 964 n.5 (2d Cir. 1993) (noting that "touch" test "seems chosen more to highlight the breadth the case advocated in interpreting the requirement than to provide a new test for the applicability of the Rule"); *In re Fin. Corp. of America Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986) ("[t]he touch test . . . is nothing more than a restatement of the 'in connection with' test"). The "touching" language used in *Bankers Life* does not articulate a test with which to determine when a fraud is in connection with a purchase or sale of securities.

Moreover, this Court has not read *Bankers Life* to mandate an any nexus test. This Court has only once cited the "touching" language, and then only in passing. *Santa Fe*, 430 U.S. at 475-76 (noting that fraud must "touch" the purchase or sale of a security while rejecting the argument that claims of breaches of fiduciary duty, without deception, constitute § 10(b) violations). In *O'Hagan*, this Court interpreted the "in connection with" language without mentioning the "touching" language. 521 U.S. at 655-59. Similarly, last Term in *Wharf (Holdings) Ltd v. United Int'l Holdings, Inc.*, 532 U.S. 588, 121 S. Ct. 1776 (2001), this Court did not reach the question of whether a misrepresentation must "relat[e] to the value of a security purchase or the consideration paid" because the representation at issue did so relate. 121 S. Ct. at 1782 (internal quotation marks and citation omitted).

Without this Court's decision in *Bankers Life* to support its alternative any nexus test, the SEC is left only with its argument that the court of appeals's interpretation of the "in connection with" requirement engrafts a "limitation on the subject matter of the prohibited deception" that is inconsistent with the language of § 10(b). Pet. Br. 39. The court of appeals articulated the requisite connection between

the deception and the securities transaction in a way prescribed, not prohibited, by the language of the statute.[26]

In particular, the SEC argues that the court of appeals unreasonably narrowed the scope of § 10(b) by holding that the fraud must relate to "investment value" or to the "attributes of a particular security" to satisfy the "in connection with" requirement. Pet. Br. 39-42. The court of appeals did not impose those limitations on § 10(b). It explicitly acknowledged that "[t]he precise contours of the in connection with requirement are not self-evident." Pet. App. 7a. However, it did conclude that "it is not so elastic as to cover incidents which bear no relationship to market integrity or investor understanding."[27] Pet. App. 7a. The SEC cites cases in which this Court and other courts have

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[26] The SEC's argument wrongly focuses attention on the deception requirement of § 10(b). The SEC is correct in asserting that the language of the statute does not limit the kinds of *deceptions* that may constitute violations of § 10(b). Pet. Br. 39. The language of the statute does limit its scope to deceptions *in connection with the purchase or sale of securities.*

[27] The court's use of the purposes of the statute to discern meaningful limitations is consistent with the approach taken by this Court in other contexts such as the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 *et seq.* This Court has drawn parallels between the phrase "in connection with" and the phrase "relate to" that appears in ERISA. *See Egelhoff v. Egelhoff*, 532 U.S. 141, 121 S. Ct. 1322, 1327 (2001) (holding "that a state law relates to an ERISA plan 'if it has a connection with or reference to such a plan'" (quoting *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 97 (1983))). But this Court has noted that those phrases cannot be taken to extend "to the furthest stretch of [their] indeterminacy, . . . for really, universally, relations stop nowhere." *New York State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 655 (1995) (internal quotation marks and citations omitted). Instead, this Court has "looked to the objectives of the . . . statute as a guide." *Id.* at 656.

found liability under § 10(b) although each "fraudulent scheme or device [was] unrelated to 'investment value.'" Pet. Br. 40. However, these examples, though not related to "investment value," are entirely consistent with the "market integrity or investor understanding" test that the court of appeals applied. Pet. App. 7a. Each case to which the SEC cites relates to the test used by the court of appeals because the fraud therein affects either market integrity[28] or investor understanding.[29] Pet. Br. 41-42. The court of appeals's interpretation of the "in connection with" requirement is thus consistent with the language of the statute.

The SEC has expressed concern that the decision below forecloses the application of § 10(b) to churning. Pet. Br. 19. Although this Court has never addressed the issue, churning is generally held to violate § 10(b). *See Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983) ("[C]hurning, in and of itself, may be a deceptive and manipulative device under section 10(b)."); *see also Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1367-68 (7th Cir. 1983); *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975). The test used by the court of appeals would reach

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[28] *See O'Hagan*, 521 U.S. at 653-54, 656 (insider trading); *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 618 (9th Cir. 1981) (misrepresentation of risks of buying on margin).

[29] *See Naftalin*, 441 U.S. at 770-71 (misrepresentation of seller that he owned stock); *Bankers Life*, 404 U.S. at 9 (seller duped into believing it would receive proceeds); *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 533 (2d Cir. 1999) (misrepresentation of date when funds from sale of security would be available); *Jakubowski*, 150 F.3d at 680-81 (misrepresentation of identity of purchaser); *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 941 (3d Cir.) (misrepresentations and nondisclosures regarding margin account interest rates), *cert. denied*, 474 U.S. 935 (1985); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 707 (2d Cir.) (misrepresentation of broker's qualifications), *cert. denied*, 449 U.S. 1011 (1980); *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1040 (7th Cir. 1974) (recognizing that churning violates § 10(b)).

churning. *See* Loss & Seligman, *supra*, at 3874 ("Churning occurs when a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business." (quoting *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 820 (9th Cir. 1980))).

Finally, interpreting the "in connection with" language in the way proposed by the SEC would give § 10(b) a reach beyond that which Congress intended. The language of § 10(b) is otherwise inclusive, applying as it does to "any person" and to "any purchase or sale of a security." The "in connection with" requirement is the limiting language in the statute. By reading the "in connection with" language as satisfied by *any* nexus, the SEC essentially strips the statute of an important and intended limit on its reach. Under the SEC's proposed test, § 10(b) would apply to an employee who stole stock certificates from his or her employer and sold them. Allowing the statute to reach so far beyond securities fraud is inconsistent with the intent of Congress.

III. THE COURT OF APPEALS'S CONCLUSION THAT ZANDFORD'S SALES OF SECURITIES WERE AUTHORIZED AND DID NOT VIOLATE § 10(b) IS CONSISTENT WITH THIS COURT'S DECISION IN *O'HAGAN*

The SEC argues that Zandford's *sales of securities* violated § 10(b) even if the *conversion of the proceeds* did not. Pet. Br. 20. It is not difficult to see what drives the SEC to this counterintuitive theory. If the sales were themselves fraudulent, the SEC would have little trouble establishing the required connection between the fraud and the sales. However, that theory depends on the odd notion that Zandford would have committed actionable (and prosecutable) securities fraud if, at the time of fully authorized sales, he had intended to convert the proceeds but then changed his mind. No precedent supports that implausible result.

The SEC relies on this Court's decision in *O'Hagan* for the proposition that a sale of a security by a fiduciary violates § 10(b) if the fiduciary is feigning loyalty at the time the sale is made. Pet. Br. 20-21. It contends that Zandford violated § 10(b) when he sold the Woods' securities because he was feigning loyalty while acting on his own behalf. Pet. Br. 20. However, *O'Hagan* does not support the SEC's use of fiduciary principles.

In *O'Hagan*, a lawyer used material, nonpublic information regarding an impending tender offer made by a client of his firm to gain risk-free profits by purchasing the target's securities. *See* 521 U.S. at 647-48, 656. O'Hagan breached his fiduciary duty by purchasing the securities without disclosing to his principal that he was using confidential information. *Id.* at 656. Adopting the misappropriation theory,[30] this Court held that § 10(b) may be violated although the deceived party is not a participant in the securities transaction. *Id.*

Although this Court announced no general "in connection with" test, several factors influenced its decision that O'Hagan's deception was in connection with a securities transaction. *See id.*; *see also United States v. Falcone*, 257 F.3d 226, 233 (2d Cir. 2001) (recognizing that, in *O'Hagan*, this Court, while "not purport[ing] to set forth the sole combination of factors necessary to establish the requisite connection" between a deception and a securities transaction, did identify considerations relevant to

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[30] The misappropriation theory complements traditional insider trading liability. *See O'Hagan*, 521 U.S. at 652. "In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id.* *See generally* Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 Hofstra L. Rev. 101 (1984).

establishing that connection). This Court observed that: (1) O'Hagan's fraud was consummated "when, without disclosure to his principal, he use[d] the information to purchase or sell securities," so that "[t]he securities transaction and the breach of duty . . . coincide[d]"; (2) misappropriated insider information is "ordinarily capitalize[d] upon to gain no-risk profits through the purchase or sale of securities"; and (3) by trading on nonpublic information, O'Hagan at once violated his fiduciary duty and "harm[ed] members of the investing public." *O'Hagan*, 521 U.S. at 656.

This Court was also concerned with the consequences of not finding O'Hagan liable under § 10(b), noting that "investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law." *Id.* at 658. This Court observed that "it makes scant sense" that O'Hagan would be a § 10(b) violator "if he work[ed] for a law firm representing the target of a tender offer, but not if he work[ed] for a law firm representing the bidder." *Id.* at 659. Insider trading implicates the core congressional purposes behind the Act. *See id.* at 658 ("The [misappropriation] theory is . . . well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."). Construing *O'Hagan* outside of the insider trading context to encompass cases like the one here leads to the concern raised by the court of appeals: "[t]his would be tantamount to endorsing an all-purpose expansion of those [securities] statutes which would violate Congress' intent and subsume significant areas of state law." Pet. App. 14a. Expanding *O'Hagan* in this way would also frustrate Congress's allocation of primary responsibility for broker regulation to SROs.

Because none of the factors or concerns that led this Court to hold that O'Hagan's deception of his principal was in connection with his purchase of securities is present here, the SEC's claim that Zandford's sale of securities is more

closely connected to a deception than was the case in *O'Hagan*, Pet. Br. 20-21, does not withstand analysis.

A. The Sales of Securities Did Not Consummate Zandford's Fraud

The SEC stretches fiduciary principles to claim that the sales of securities—as opposed to their subsequent conversion—consummated a fraud. It first cites Charles H. Meyer, *The Law of Stockbrokers and Stock Exchange* (1931), for the proposition that "[r]espondent's sale of the Woods' securities for the undisclosed purpose of benefitting himself (by furthering his plan to misappropriate the proceeds) was a fraudulent conversion and embezzlement of the securities themselves." Pet. Br. 18 (citing Meyer, *supra*, § 136, at 552). Meyer, however, states that "[t]he *wrongful sale* of a customer's securities is a conversion of the securities." Meyer, *supra*, § 136 at 552 (emphasis added). The cases Meyer cites for support involve brokers who had *no* authority to make any purchases or sales in their clients' accounts without prior authorization; it was the lack of authority, not a mere intent to convert the proceeds later, that made the sales "wrongful." *See, e.g., Keller v. Halsey*, 202 N.Y. 588, 590-94, 597-98, 95 N.E. 634, 635-38 (1911) (holding that broker converted client's assets when he agreed to carry client's shares until the client directed them to be sold but sold the stocks without authority from the client or notice to him); *Mullen v. J.J. Quinlan & Co.*, 195 N.Y. 109, 115, 87 N.E. 1078, 1080 (1909) (holding that a sale of stock "without notice to, or the consent of," the owners constituted a conversion where "[t]here was no agreement permitting it and there was no default on their part justifying the act").[31]

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[31] In addition to Meyer, the SEC also cites two state cases for this proposition. Pet. Br. 18 (citing *Taussig v. Hart*, 58 N.Y. 425 (1874); *Sherman v. State*, 124 Tex. Crim. 205, 208 (Tex. Crim. App. 1933)). In *Taussig*, the particular transaction was itself unauthorized. 58 N.Y. at 426-27 (agreement specified that stocks and gold should be

By contrast, there is no evidence that Zandford's sales of securities were wrongful. Zandford was authorized, by virtue of the discretionary nature of the Woods' account, to engage in securities transactions without specific authorization for each transaction. Pet. App. 10a. The SEC never established what securities were in the account or sold by Zandford, and, for purposes of summary judgment, it made no attempt to show that the stocks were themselves inappropriate for purchase or sale. Although there may have been a fraudulent scheme, it did not render all subsequent actions unauthorized. *See, e.g.*, Restatement (Second) of Contracts § 163 cmt. c. (1979); *Langley v. FDIC*, 484 U.S. 86, 94 (1987) (noting that fraud in the inducement rendered a promissory note "*voidable* but not void" (emphasis added)). In the absence of further evidence about the sales, given that the SEC exclusively relied on the wire-fraud-indictment facts for summary judgment purposes, the SEC has not established that the sales were deceptive.

Next, the SEC claims that the sales were a fraudulent conversion independent of the conversion of the proceeds because Zandford failed to disclose his feigned loyalty. Pet. Br. 20. For purposes of § 10(b), nondisclosure must refer to facts that are withheld by a fiduciary at the time of the sale, not wholly subjective intentions that are not integral to a securities transaction. *Cf. O'Hagan*, 521 U.S. at 655-56 (breach of duty occurred not when O'Hagan acquired the information but when he used it to purchase securities without disclosing that use to the principal).

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purchased or sold "regular," but broker purchased them at "seller's option"). In *Sherman*, there was evidence that the authorization for the sale of particular stocks was induced by deception. 124 Tex. Crim. at 206, 61 S.W.2d 488, 489 (Tex. Crim. App. 1933) (client induced to transfer stock for sale by defendant based on defendant's fraudulent misrepresentations).

To allow the SEC to bootstrap Zandford's subjective intent into a § 10(b) violation without showing any effect on any securities transaction would undermine this Court's ruling in *Santa Fe* that limited the scope of § 10(b) to breaches of fiduciary duty that are independently manipulative or deceptive. 430 U.S. at 473-74. *Santa Fe* underscores that "§ 10(b) is not an all-purpose breach of fiduciary duty ban." *O'Hagan*, 521 U.S. at 655; *see also* Donald C. Langevoort, *Corporate Accountability: Seeking Sunlight in Santa Fe's Shadow*, 79 Wash. U. L.Q. 449, 456 (2001) ("[T]he subject of the alleged nondisclosure must be the underlying facts from which the possibility of a breach may be inferred. With citation to *Santa Fe*, courts consistently say that corporate managers are not expected to characterize their accusations in pejorative terms (self-accusations) or *volunteer information about their subjective motivations*." (emphasis added)).

After *Santa Fe*, as the Second Circuit noted in *Pross*, "generalized promises to act as a faithful fiduciary stand on a different footing than other promises of future performance. It is clear that a breach of a fiduciary duty by itself is not sufficient to make out a federal claim." 784 F.2d at 458 (citing *Santa Fe*); *see also Kas v. Fin. Gen. Bankshares, Inc.*, 796 F.2d 508, 513 (D.C. Cir. 1986) ("a plaintiff may not 'bootstrap' a claim of breach of fiduciary duty into a federal securities claim by alleging that directors failed to disclose that breach of fiduciary duty"); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 288 (7th Cir.) ("In the wake of *Santa Fe*, courts have consistently held that since a shareholder cannot recover under 10b-5 for a breach of fiduciary duty, neither can he 'bootstrap' such a claim into a federal securities action by alleging that the disclosure philosophy of the statute obligates defendants to reveal either the culpability of their activities, or their impure motives for entering the allegedly improper transaction."), *cert. denied*, 454 U.S. 1092 (1981). This is not to say that promissory fraud that induces an investment decision would not be actionable under

§ 10(b). *See Wharf (Holdings)*, 121 S. Ct. at 1781-82 (holding that Wharf's secret intent not to honor an option that it sold violated § 10(b) because, among other factors, its secret intent rendered the option valueless). However, a generalized promise that does not induce an investment decision cannot form the basis of a § 10(b) violation.

The SEC cannot establish a § 10(b) violation based entirely on what Zandford was thinking. Accepting the contrary premise would lead to the implausible result that any broker who at some point harbored impure thoughts regarding a securities transaction would be liable under § 10(b), even if he abandoned his intention and never consummated the fraud. *See Pross*, 784 F.2d at 459 ("An intent to cause a conversion of ownership interests at some uncertain future time and through uncertain means does not bring federal law into play, even though that intent is held at the time a purchase or sale of securities occurs."). *Pross* involved a two-year lapse between the securities transactions and the conversion. *See id.* at 656-57. Although there is no comparable delay here, the same deficiency exists. The SEC failed to prove that the securities transactions were unauthorized. Rather, it was the conversion of the proceeds, through three contractual arrangements, that was found to be fraudulent. Pet. App. 36a-37a. Zandford's deception related to these arrangements, not to the securities sales themselves.

The SEC's emphasis on Zandford's state of mind, followed to its logical conclusion, conflicts with this Court's reasoning in *O'Hagan*. If anything, Zandford embezzled the Woods' funds—not their stocks—because he allegedly harbored the subjective intent to convert the funds when he obtained control of them. As the court of appeals noted, based on *O'Hagan*, purchasing stocks with embezzled funds does not implicate § 10(b):

> [This] Court also noted, with apparent approval, the government's contention that § 10(b) would not apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeeds to purchase securities. . . . The same logic applies to Zandford's fraudulent conduct.

Pet. App. 12a (citations omitted).

B. The Other Factors Underlying this Court's Holding in *O'Hagan* Are Not Present Here

In addition to the fact that O'Hagan's fraud was consummated by the securities transaction, this Court took two other factors into consideration in its analysis of the "in connection with" requirement. This Court declared it significant that insider information ordinarily had value only if used in a subsequent stock transaction. *O'Hagan*, 521 U.S. at 657. That factor was important to its analysis of the "in connection with" requirement because it made the securities transaction an essential part of O'Hagan's scheme. *See id.* at 656-57. That is not the case here. The court of appeals correctly recognized that, because Zandford had control of the money before any securities transactions took place, his "sales were incidental to his scheme to defraud." Pet. App. 9a. Indeed, in affirming Zandford's wire fraud conviction, the court of appeals addressed the sufficiency of the evidence to convict without mentioning any securities transactions. Pet. App. 36a-37a.

This Court also noted that the securities transactions in *O'Hagan* at once deceived the principal and harmed investors who sold securities due to an unfair informational disadvantage "vis-à-vis a misappropriator with material, nonpublic information." 521 U.S. at 658-59. By contrast, Zandford's sales were not shown to be harmful independent of the subsequent conversion of the proceeds, and they affected no investment decision. Pet. App. 13a ("Zandford's statements or omissions were not about a particular security. Nor did his omissions induce the Woods or anyone else to buy or sell a particular stock."). As the court of appeals correctly concluded, "[t]he misappropriated proceeds might

as well have come from the unlawful sale of a car which the Woods had entrusted to Zandford's care." Pet. App. 12a.

IV. THE SEC'S INTERPRETATION IS NOT ENTITLED TO *CHEVRON* DEFERENCE

The SEC contends that its "interpretation of Section 10(b) and Rule 10b-5 . . . must be given effect by the courts" under the doctrine of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984), Pet. Br. 38, and that it "has interpreted Section 10(b) and Rule 10b–5 to prohibit the fraudulent misappropriation by broker-dealers . . . of customer securities and the proceeds of securities sales." Pet. Br. 34–35. Both of these contentions are incorrect. First, this Court has never held that Congress gave the SEC the power to interpret the "in connection with" requirement of § 10(b) authoritatively, and the SEC has never previously requested that this Court defer to its interpretations of § 10(b). Second, the agency adjudications to which the SEC asks this Court to defer lack the rigorous analysis and interpretation of § 10(b) or Rule 10b-5 necessary to warrant *Chevron* deference. For these reasons, the SEC is not entitled to the deference it seeks.

A. Both this Court and the SEC Have Traditionally Understood that the SEC's Interpretation Is Not Entitled to *Chevron* Deference

The SEC's interpretation of § 10(b) is entitled to *Chevron* deference only if Congress intended to delegate to the agency the authority to speak with the force of law. *See Mead*, 121 S. Ct. at 2172 & n.11; *Chevron*, 467 U.S. at 865. Although the SEC enjoys some expressly delegated rulemaking authority under § 10(b), including the power to promulgate Rule 10b-5, the Act does not allow the agency to define the "in connection with" limitation. *See Adams Fruit Co. v. Barrett*, 494 U.S. 638, 650 (1990) (holding that express grant of authority to promulgate standards under statute did not empower agency to regulate the scope of judicial power

thereunder). The long-standing practice of this Court, as well as the SEC, strongly implies that the SEC lacks this authority.

Though eighteen years have passed since *Chevron* was decided, the SEC cites no case in which it has taken the position that Congress intended the courts to defer to its interpretation of § 10(b). During that period, this Court decided many § 10(b) cases, and the SEC filed more than a dozen party and amicus briefs without requesting *Chevron* deference.[32] Even when this Court found "the SEC's insights . . . helpful" and accorded them an unspecified level of "due deference," it reached its conclusion without invoking the *Chevron* doctrine. *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.16 (1988). Indeed, the SEC's helpful insights were merely that it approved of the Second Circuit's interpretation of § 10(b) in *Texas Gulf Sulphur*. *See Basic Inc.*, 485 U.S. at 239 n.16.

This Court's (and the SEC's own) understanding of the limits of the SEC's entitlement to *Chevron* deference is well-illustrated in *O'Hagan* (and the SEC's brief in that case). Though *O'Hagan* raised questions about the proper application of the "in connection with" requirement of § 10(b), the government did not request, and this Court did not grant, *Chevron* deference to the SEC's interpretation of that language. The government's failure to request deference under § 10(b) is significant because, in the same case, it did ask for deference for the SEC's interpretation of

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[32] This Court has reviewed § 10(b) without deferring to the SEC's interpretation. *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 176-77 (1994) (rejecting the SEC's position regarding the coverage of aiding and abetting under Rule 10b-5); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361-62 (1991) (rejecting the SEC's position regarding the length of a federal statute of limitations for Rule 10b-5 actions); *Aaron*, 446 U.S. 680, 701-02 (rejecting the SEC's position that injunctive enforcement under § 10(b) does not require scienter).

§ 14(e). Brief for the United States at 36, 41, *O'Hagan* (No. 96-842). This Court, while granting deference to the SEC's interpretation of § 14(e), also noted that § 10(b) was not subject to the same analysis. *O'Hagan*, 521 U.S. at 673. As this Court's opinion makes clear, the SEC's rulemaking authority under § 10(b) is more limited than under § 14(e). *See id.* at 651, 657.

This Court's failure to grant *Chevron* deference reflects an understanding long shared by the SEC and this Court that Congress intended for the judiciary to define the limits of § 10(b) without deferring to the SEC's interpretation. Rather, Congress granted the SEC rulemaking powers "to catalogue deceptive and manipulative devices and practices prohibited under Section 10(b)," Pet. Br. 37, but the courts determine the meaning of "in connection with the purchase or sale of a security." *See Ernst & Ernst*, 425 U.S. at 214 (holding that "despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b)").

The broad reach of § 10(b) also suggests that Congress did not intend to grant deference to the SEC regarding the scope of § 10(b). The provision's expansive language reaches *any* purchase or sale and applies to *any* person acting under a broad range of circumstances. Section 10(b) gives rise to SEC and implied private rights of action, *see Bankers Life*, 404 U.S. at 13 n.9, and can also serve as the basis for a criminal prosecution. *See* § 32(a). Given the broad implications of § 10(b), and the variety of non-SEC initiated actions that the courts must adjudicate, deference to the SEC is particularly inappropriate. *Cf. Adams Fruit*, 494 U.S. at 649 (finding deference inappropriate when Congress has expressly established the judiciary as adjudicator of private rights of action).

For these reasons, it is implausible to conclude that Congress intended for the courts to defer to the SEC's interpretation of § 10(b). However, even if Congress in 1934

had intended to allow the SEC to set the limits of its own § 10(b) jurisdiction, the intervening sixty-eight years of non-deferential review have created settled case law to the contrary. *See Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990) ("Once we have determined a statute's clear meaning, we adhere to that determination under the doctrine of stare decisis, and we judge an agency's later interpretation of the statute against our prior determination of the statute's meaning.").

B. The Sources on Which the SEC Relies Do Not Constitute an Authoritative Agency Interpretation

To support its claim of an authoritative agency interpretation of § 10(b), the SEC relies on a series of its public announcements,[33] and this Court's holding that agency adjudications can be worthy of *Chevron* deference. Pet. Br. 37 (citing *Mead*, 121 S. Ct. at 2171). However, "[t]o say that *Chevron* governs a particular case is not to assume that it applies equally to all agency adjudications." *Bob Evans Farms v. NLRB*, 163 F.3d 1012, 1019 (7th Cir. 1998) (analyzing the proper deference given to agency adjudication and concluding that though the NLRB "can, and occasionally does, make rules in the course of adjudication, the bulk of its orders have only a slight legislative dimension"). The difference between the SEC's materials and the agency adjudications cited by this Court in *Mead* as deserving deference is telling.

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[33] The SEC also cites two district court opinions, neither of which is relevant to the question of whether the SEC has articulated an authoritative interpretation of Rule 10b-5. Pet. Br. 35 & n.12. In *SEC v. Lawson*, 24 F. Supp. 360 (D. Md. 1938), § 10(b) was not raised; in fact, the case was decided four years before the enactment of Rule 10b-5. In *Cooper*, 226 F. Supp. at 978, the court merely noted that the SEC had frequently taken action against brokers who had defrauded clients out of funds.

The adjudications referenced in *Mead*, 121 S. Ct. at 2173 n.12, are much like published court opinions. They contain extensive legal analysis, including examination of the underlying statutory language and the elements of the provision. *See, e.g., ABF Freight Sys.*, 304 N.L.R.B. 585 (1991) (deferred to in *ABF Freight Sys., Inc. v. NLRB*, 510 U.S. 317, 324-325 (1994)); *Imco Poultry*, 202 N.L.R.B. 259 (1973) (deferred to in *Holly Farms Corp. v. NLRB*, 517 U.S. 392, 401-03 (1996)). In comparison, none of the SEC releases, Pet. Br. 35 & n.12, 36 & n.13, provides any analysis of the terms used in § 10(b) or states the rule for which the agency now seeks deference.[34] Rather, each of the releases merely recites factual circumstances and, without any analysis of the statutory requirements, summarily concludes that those circumstances constitute a violation of Rule 10b-5. *See, e.g., Southeastern Sec. Corp.*, Exchange Act Release No. 4,274 (1949) (consisting of extensive factual recapitulation followed by summary findings of Rule 10b-5 violations). Indeed, the case on which the SEC most heavily relies contains virtually no legal analysis. *See Kenneth Leo Bauer*, Exchange Act Release No. 4,006 (1947) (containing only a

[34] The SEC primarily relies on Exchange Act Releases, describing SEC agency adjudications, and Litigation Releases, describing court proceedings to which the SEC is party. Such releases have "less precedential and predictive value than do rules that are promulgated as a result of the more formal interpretive rule-making process." 1 Thomas Lee Hazen, *Law of Securities Regulation* 17 (3d ed. 1996); *see SEC v. Adler*, 137 F.3d 1325, 1339 (11th Cir. 1998) (declining to defer to SEC interpretation of § 10(b) contained in SEC report, congressional testimony, and litigation because, among other reasons, SEC material failed to provide legal analysis); *Amalgamated Clothing & Textile Workers Union v. SEC*, 15 F.3d 254, 257 n.3 (2d Cir. 1994) (noting SEC concession that some informal statements such as no-action letters or Commission comments thereon are not entitled to the *Chevron* deference afforded to formal policy statements or rulemaking orders).

one-sentence conclusion declaring defendant, who made no appearance at hearing, in violation of Rule 10b-5).

The SEC adjudications simply do not exhibit the "relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force." *Mead*, 121 S. Ct. at 2172 (explaining the indicia of congressional intent to confer law-making power upon an agency); *see also SEC v. Sloan*, 436 U.S. 103, 117-18 (1978) ("[S]ince this Court can only speculate as to the Commission's reasons for reaching the conclusion that it did, the mere issuance of consecutive summary suspension orders, without a concomitant exegesis of the statutory authority for doing so, obviously lacks 'power to persuade' as to the existence of such authority.") (citing *Adamo Wrecking Co. v. United States*, 434 U.S. 275, 287 n.5 (1978)). Nor do the arguments offered for the first time by the SEC in its brief close the analytical gap in the agency's jurisprudence because "courts may not accept appellate counsel's post hoc rationalizations" as substitutes for considered agency declarations.[35] *Bowen v. Georgetown Univ.*

[35] Giving *Chevron* deference to such announcements would also allow agencies to interpret statutes without appropriate analytical rigor and, thereby, defeat the Administrative Procedure Act's purpose of assuring due deliberation. *See Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 741 (1996). Both the now chairman of the SEC and a former commissioner have recognized that one of the "dangers inherent in the administrative process is that agencies will eschew formal rulemaking for *ad hoc* enforcement actions, using discrete enforcement proceedings as a vehicle for developing new legal standards as the need arises." Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 Yale J. on Reg. 149, 168 (1990); *accord* Roberta S. Karmel, *Creating Law at the Securities and Exchange Commission: The Lawyer as Prosecutor*, 61 Law & Contemp. Prob. 33, 42 (1998).

Hosp., 488 U.S. 204, 212 (1988) (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)).

Finally, even if *Chevron* analysis were appropriate here, it would not advance the SEC's case. The SEC's proposed interpretation, that § 10(b) is violated any time a broker misappropriates a client's funds or securities, could not survive *Chevron* scrutiny because it is an unreasonable interpretation "manifestly contrary" to the established law of § 10(b). 467 U.S. at 844. Courts have recognized that application of § 10(b)'s "in connection with" language can be difficult. *See, e.g., Chem. Bank*, 726 F.2d at 942; Loss & Seligman, *supra*, at 3680 & n.558. Accordingly, the courts have consistently determined the contours of § 10(b) through *de novo* case-by-case adjudication. *See, e.g., Central Bank*, 511 U.S. at 172-73 (collecting cases in which this Court has defined the contours of § 10(b)). Thus, it would be unreasonable for the SEC to adopt the *per se* standard it proposes here.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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FEBRUARY 4, 2002

APPENDIX

§ 2, 15 U.S.C. § 78b. NECESSITY FOR REGULATION

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally disseminated and quoted

throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

§ 9, 15 U.S.C. § 78i. MANIPULATION OF SECURITY PRICES

(a) Transactions relating to purchase or sale of security

It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of

interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange—

(1) For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange or in connection with any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

(3) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, to induce the purchase or sale of any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security by the circulation or dissemination in the ordinary course of

business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(4) If a dealer or broker, or the person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, to make, regarding any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, for the purpose of inducing the purchase or sale of such security or such security-based swap agreement, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

(5) For a consideration, received directly or indirectly from a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, to induce the purchase of any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(6) To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and

regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§ 15, 15 U.S.C. § 78o. REGISTRATION AND REGULATION OF BROKERS AND DEALERS

(b) Manner of registration of brokers and dealers

* * * * *

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated –

* * * * *

(B) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which the Commission finds –

(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, any substantially equivalent activity however denominated by the laws of the relevant foreign government, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered

under the Commodity Exchange Act (7 U.S.C. 1 et seq.) or any substantially equivalent foreign statute or regulation;

(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or substantially equivalent activity however denominated by the laws of the relevant foreign government; or

(iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of Title 18, or a violation of a substantially equivalent foreign statute.

* * * * *

(8) It shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than or [sic] commercial paper, bankers' acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to section 78o-3 of this title or effects transactions in securities solely on a national securities exchange of which it is a member.

* * * * *

(c) Use of manipulative or deceptive devices; contravention of rules and regulations

(1)(A) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), by means of any manipulative, deceptive, or other fraudulent device or contrivance.

* * * * *

(2)(A) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to

effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.

* * * * *

(D) The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

* * * * *

(3)(A) No broker or dealer (other than a government securities broker or government securities dealer, except a registered broker or dealer) shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security (except a government security) or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum financial responsibility requirements for all brokers and dealers.

* * * * *

(4) If the Commission finds, after notice and opportunity for a hearing, that any person subject to the provisions of section 78l, 78m, 78n of this tile, or subsection (d) of this section or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply, to comply, or to take steps to effect compliance, with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.

(5) No dealer (other than a specialist registered on a national securities exchange) acting in the capacity of market maker or otherwise shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or a municipal security) in contravention of such specified and appropriate standards with respect to dealing as the Commission, by rule, shall prescribe as necessary or appropriate in the public interest and for the protection of investors, to maintain fair and orderly markets, or to remove impediments to and perfect the mechanism of a national market system. Under the rules of the Commission a dealer in a security may be prohibited from acting as a broker in that security.

(6) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security, municipal security, commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the

protection of investors or to perfect or remove impediments to a national system for the prompt and accurate clearance and settlement of securities transactions, with respect to the time and method of, and the form and format of documents used in connection with, making settlements of and payments for transactions in securities, making transfers and deliveries of securities, and closing accounts. Nothing in this paragraph shall be construed (A) to affect the authority of the Board of Governors of the Federal Reserve System, pursuant to section 78g of this title, to prescribe rules and regulations for the purpose of preventing the excessive use of credit for the purchase or carrying of securities, or (B) to authorize the Commission to prescribe rules or regulations for such purpose.

* * * * *

§ 15A, 15 U.S.C. § 78o-3. REGISTERED SECURITIES ASSOCIATIONS

(b) Determinations by Commission requisite to registration of applicant as national securities association

An association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that—

* * * * *

(6) The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum

profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the association.

(7) The rules of the association provide that (subject to any rule or order of the Commission pursuant to section 78q(d) or 78s(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of any provision of this chapter, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or the rules of the association, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

* * * * *

§ 19, 15 U.S.C. § 78s. REGISTRATION, RESPONSIBILITIES, AND OVERSIGHT OF SELF-REGULATORY ORGANIZATIONS

(b) Proposed rule changes; notice; proceedings

(1) Each self-regulatory organization shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such self-regulatory organization (hereinafter in this subsection collectively referred to as a "proposed rule change") accompanied by a concise general statement of the basis and purpose of such proposed rule change. The Commission shall, upon the filing of any proposed rule change, publish notice thereof together with the terms of substance of the proposed rule change or a description of the subjects and issues involved. The Commission shall give interested persons an opportunity to submit written data, views, and arguments concerning such proposed rule

change. No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.

(2) Within thirty-five days of the date of publication of notice of the filing of a proposed rule change in accordance with paragraph (1) of this subsection, or within such longer period as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or as to which the self-regulatory organization consents, the Commission shall—

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved. Such proceedings shall include notice of the grounds for disapproval under consideration and opportunity for hearing and be concluded within one hundred eighty days of the date of publication of notice of the filing of the proposed rule change. At the conclusion of such proceedings the Commission, by order, shall approve or disapprove such proposed rule change. The Commission may extend the time for conclusion of such proceedings for up to sixty days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the self-regulatory organization consents.

The Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this chapter and the rules and regulations thereunder applicable to such organization. The Commission shall disapprove a proposed rule change of a self-regulatory organization if it does not make such finding. The Commission shall not approve any proposed rule change prior to the thirtieth day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding.

(3)(A) Notwithstanding the provisions of paragraph (2) of this subsection, a proposed rule change may take effect upon filing with the Commission if designated by the self-regulatory organization as (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization, (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization, or (iii) concerned solely with the administration of the self-regulatory organization or other matters which the Commission, by rule, consistent with the public interest and the purposes of this subsection, may specify as without the provisions of such paragraph (2).

(B) Notwithstanding any other provision of this subsection, a proposed rule change may be put into effect summarily if it appears to the Commission that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds. Any proposed rule change so put into effect shall be filed promptly thereafter in accordance with the provisions of paragraph (1) of this subsection.

(C) Any proposed rule change of a self-regulatory organization which has taken effect pursuant to subparagraph (A) or (B) of this paragraph may be enforced by such organization to the extent it is not inconsistent with the provisions of this chapter, the rules and regulations thereunder, and applicable Federal and State law. At any time within sixty days of the date of filing of such a proposed rule change in accordance with the provisions of paragraph (1) of this subsection, the Commission summarily may abrogate the change in the rules of the self-regulatory organization made thereby and require that the proposed rule change be refiled in accordance with the provisions of paragraph (1) of this subsection and reviewed in accordance with the provisions of paragraph (2) of this subsection, if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of

investors, or otherwise in furtherance of the purposes of this chapter. Commission action pursuant to the preceding sentence shall not affect the validity or force of the rule change during the period it was in effect and shall not be reviewable under section 78y of this title nor deemed to be "final agency action" for purposes of section 704 of Title 5.

* * * * *

(c) Amendment by Commission of rules of self-regulatory organizations

The Commission, by rule, may abrogate, add to, and delete from (hereinafter in this subsection collectively referred to as "amend") the rules of a self-regulatory organization (other than a registered clearing agency) as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this chapter, in the following manner:

(1) The Commission shall notify the self-regulatory organization and publish notice of the proposed rulemaking in the Federal Register. The notice shall include the text of the proposed amendment to the rules of the self-regulatory organization and a statement of the Commission's reasons, including any pertinent facts, for commencing such proposed rulemaking.

(2) The Commission shall give interested persons an opportunity for the oral presentation of data, views, and arguments, in addition to an opportunity to make written submissions. A transcript shall be kept of any oral presentation.

(3) A rule adopted pursuant to this subsection shall incorporate the text of the amendment to the rules of the self-regulatory organization and a statement of the Commission's basis for and purpose in so amending such rules. This statement shall include an identification of any

facts on which the Commission considers its determination so to amend the rules of the self-regulatory agency to be based, including the reasons for the Commission's conclusions as to any of such facts which were disputed in the rulemaking.

(4)(A) Except as provided in paragraphs (1) through (3) of this subsection, rulemaking under this subsection shall be in accordance with the procedures specified in section 553 of Title 5 for rulemaking not on the record.

(B) Nothing in this subsection shall be construed to impair or limit the Commission's power to make, or to modify or alter the procedures the Commission may follow in making, rules and regulations pursuant to any other authority under this chapter.

(C) Any amendment to the rules of a self-regulatory organization made by the Commission pursuant to this subsection shall be considered for all purposes of this chapter to be part of the rules of such self-regulatory organization and shall not be considered to be a rule of the Commission.

(5) With respect to rules described in subsection (b)(5) of this section, the Commission shall consult with and consider the views of the Secretary of the Treasury before abrogating, adding to, and deleting from such rules, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor.

§ 21, 15 U.S.C. § 78u. INVESTIGATIONS AND ACTIONS

(d) Injunction proceedings; authority of court to prohibit persons from serving as officers and directors; money penalties in civil actions

(1) Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, the rules of a national

securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

* * * * *

(e) Mandamus

Upon application of the Commission the district courts of the United States and the United States courts of any territory or other place subject to the jurisdiction of the United States shall have jurisdiction to issue writs of mandamus, injunctions, and orders commanding (1) any person to comply with the provisions of this chapter, the rules, regulations, and orders thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or person associated with a member, the rules of a registered clearing agency in which such person is a participant, the rules of the Municipal Securities Rulemaking Board, or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, (2) any national securities exchange or registered securities association to enforce compliance by its members and persons associated with its members with the provisions of this chapter, the

rules, regulations, and orders thereunder, and the rules of such exchange or association, or (3) any registered clearing agency to enforce compliance by its participants with the provisions of the rules of such clearing agency.

(f) Rules of self-regulatory organizations

Notwithstanding any other provision of this chapter, the Commission shall not bring any action pursuant to subsection (d) or (e) of this section against any person for violation of, or to command compliance with, the rules of a self-regulatory organization unless it appears to the Commission that (1) such self-regulatory organization is unable or unwilling to take appropriate action against such person in the public interest and for the protection of investors, or (2) such action is otherwise necessary or appropriate in the public interest or for the protection of investors.

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FILED
MAR 6 2002

No. 01-147

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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In the Supreme Court of the United States

No. 01-147

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

Section 10(b) and Rule 10b-5 prohibit "(1) using any deceptive device (2) in connection with the purchase or sale of securities." *United States* v. *O'Hagan*, 521 U.S. 642, 651 (1997). Respondent violated those provisions both when he sold, for his own benefit, securities that the Woods had entrusted to him as their stockbroker and fiduciary *and* when he converted the sales proceeds to his own use, all without disclosure or authorization.

1. Respondent's Sales Of The Woods' Securities For His Own Benefit Were Fraudulent, And That Fraud Was Inherently "In Connection With" The Sales

Respondent concedes (Br. 34) that the "in connection with" requirement is satisfied if his sales of the Woods' securities were themselves fraudulent. Those sales were indeed fraudulent. See Gov't Br. 15-19. The court of appeals

recognized, and respondent apparently does not contest, that he was the Woods' fiduciary because he had discretionary authority to invest on their behalf. See Pet. App. 14a; 8 L. Loss & J. Seligman, *Securities Regulation* 3826 (3d. ed. 1991). As the Woods' fiduciary, respondent had a duty to act only for their benefit when selling securities in their accounts. See Restatement (Second) of Agency § 387; *id.* § 425 & cmt. f. He also had a duty to disclose to the Woods all information pertinent to his handling of their accounts—including any conflict of interest that he had in selling their securities. See *id.* § 381; *Hughes* v. *SEC*, 174 F.2d 969, 975-976 (D.C. Cir. 1949) (stockbroker having fiduciary relationship with clients had duty to disclose conflict of interest in recommending or executing transactions, and failure to disclose violated Section 10(b)).

Thus, when respondent secretly sold the Woods' securities for his own purposes, he simultaneously breached his fiduciary duty and committed fraud. See *O'Hagan*, 521 U.S. at 653-654 (fiduciary who pretends loyalty to principal while secretly converting principal's property for personal gain defrauds principal); C.H. Meyer, *The Law of Stockbrokers and Stock Exchange* § 136, at 552 (1931) (stockbroker's wrongful sale of customer's stock is conversion); *Sherman* v. *State*, 124 Tex. Crim. 205, 208 (1933) (per curiam) (agent's sale of stock with intent to misappropriate proceeds is embezzlement of stock itself).

a. Respondent erroneously contends that the sales were not fraudulent because he "was authorized, by virtue of the discretionary nature of the Woods' account, to engage in securities transactions without specific authorization for each transaction." Br. 38. Under the agency principles discussed above, discretionary authority does not give the broker license to use a client's assets *for his own enrichment.* Discretionary authority to invest extends only to actions *in the principal's interest* and consistent with his instructions.

See *Sherman*, 124 Tex. Crim. at 207-208 ("Notwithstanding that appellant may have had authority to make the sale of the stock alleged to have been embezzled, yet, if he sold the same with the formed intention to defraud the owner and to convert the proceeds to his own use and benefit, he is as much guilty of embezzlement of the stock as if he had no authority to make such sale."); *Norris & Hirshberg, Inc.* v. *SEC*, 177 F.2d 228, 231-232 (D.C. Cir. 1949) (firm liable under Section 10(b) for "omission to fully disclose its trading practices and its adverse position to its customers," including fifteen who "had given petitioner express discretionary powers over their accounts"); *Bennett* v. *Hungate*, 291 F. 895, 898 (S.D.N.Y. 1922) (L. Hand, J.) (agent authorized to "invest" money for a friend "in sound investments" was not authorized to buy stock on margin); p. 9, *infra* (discussing churning cases). It would be contrary to general agency principles—not to mention common sense—to hold that a customer's authorization for a stockbroker to make investments on the customer's behalf authorizes the broker to sell them for the broker's own benefit.

b. Respondent asserts that the SEC's position "depends on the odd notion that [respondent] would have committed actionable * * * securities fraud if * * * he had intended to convert the proceeds [at the time of the sales] but then changed his mind." Br. 34; see also Resp. Br. 40. That assertion is unfounded.

First, the SEC's argument in *this* case does not depend on any such "notion" because respondent did not change his mind—he carried out his intent to convert the proceeds. Second, there is nothing "odd" about the principle that a sale of securities with wrongful intent constitutes an actionable fraud in its own right. That conclusion does not "stretch[] fiduciary principles" (Br. 37); it follows directly from them. See *Sherman*, 124 Tex. Crim. at 208 (otherwise, "someone who sold property entrusted to him for sale and absconded

with the proceeds, on being accused of embezzlement of the proceeds of the sale, will defend on the theory that what he embezzled was the property itself, and vice versa"); Meyer, *supra*, § 136 at 554, 557 (broker's wrongful sale of securities is a conversion even when customer is credited with sales proceeds); W. La Fave, *Criminal Law* § 8.6, at 827 (3d ed. 2000) (someone who converts property entrusted to him with fraudulent intent is guilty of embezzlement even if he later returns the property or if he intended to and does return property of equivalent value). Indeed, this Court endorsed a similar principle more than 75 years ago when it held that a fiduciary who leased a minor's property with a secret agreement that the fiduciary would have a partial interest in the lease committed fraud whether or not the minor was injured by the lease, because "[i]t is sufficient to establish that the fiduciary has exercised his power of disposition for his own benefit without more." *United States* v. *Dunn*, 268 U.S. 121, 131 (1925).[1]

c. Respondent also contends that the undisclosed intent to convert the proceeds cannot render a sale fraudulent because non-disclosure must refer to withheld "facts," "not wholly subjective intentions." Br. 38. That contention cannot be reconciled with this Court's recent ruling in *The Wharf (Holdings) Ltd.* v. *United Int'l Holdings, Inc.*, 532 U.S. 588 (2001), that the sale of an option with a secret intent

[1] A private plaintiff seeking damages might not be able to recover under Section 10(b) based solely on a sale with the intent to convert the proceeds: such a plaintiff must prove injury resulting from the deception (see note 3, *infra*), and, if the sales price was fair and the proceeds were not converted, there might be no injury. The government, however, need not show injury to state a claim under Section 10(b), but only that the defendant, with scienter, used deception "in connection with the purchase or sale of any security." Of course, when a stockbroker does not carry through with his intent to convert the proceeds, the government may have more difficulty proving that he had that intent at the time of the sale.

not to honor it violates Section 10(b). Nor can it be reconciled with the well-established principle that fraud may be based on the undisclosed intent not to perform a promise. See *Durland* v. *United States*, 161 U.S. 306, 312-314 (1896); Restatement (Second) of Torts § 530 cmt. c (1977).

Respondent attempts to reconcile his argument with *Wharf* and general tort principles by contending that the failure to disclose a breach of a "generalized promise[] to act as a faithful fiduciary" cannot constitute deception prohibited by Section 10(b). See Resp. Br. 39 (quoting *Pross* v. *Katz*, 784 F.2d 455, 458 (2d Cir. 1986)). That contention is based on a misinterpretation of this Court's decision in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977). Some court of appeals decisions (including *Pross* and two others cited by respondent (Br. 39)) initially interpreted *Santa Fe* as holding that deception concerning a breach of fiduciary duty cannot support a Section 10(b) action. Subsequent decisions of this Court, however, have made clear that those court of appeals decisions were incorrect. *Santa Fe* holds only that there can be no violation of Section 10(b) without deception; it does not hold that a breach of fiduciary duty that involves deception cannot form the basis for a violation. See *O'Hagan*, 521 U.S. at 655. Indeed, in *O'Hagan*, this Court upheld a criminal conviction under Section 10(b) and Rule 10b-5 based on the defendant's failure to disclose that he was acting in breach of his fiduciary duty. See also *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1090-1098 (1991).[2]

[2] Despite its misinterpretation of *Santa Fe*, the Second Circuit recognized in *Pross* that fraudulent conversion of securities sometimes violates Section 10(b). The court held that "a securities transaction that entails as one of its integral steps the fraudulent securing of blank signature pages for purposes of a later conversion" is "a fraud 'in connection with the purchase or sale' of securities,'" and it remanded the case to allow the plaintiff to amend his complaint to include those allegations. 784 F.2d at 459.

2. Respondent's Conversion Of The Proceeds Of The Securities Sales Was Fraud "In Connection With" The Sales

Respondent also committed fraud when he misappropriated the proceeds of his sales of the Woods' securities while continuing the pretense that he was acting as a loyal fiduciary. See *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 10 & n.7 (1971); *Grin* v. *Shine*, 187 U.S. 181, 189 (1902); Gov't Br. 15-18. That fraud was "in connection with" the sales of the Woods' securities, because respondent made the sales in order to generate the proceeds that he planned to embezzle. See *id.* at 21-22.

a. Respondent argues (Br. 23-25) that his fraudulent conversion of the proceeds was not "in connection with" the sales because his deception did not "pertain[] to the securities themselves." Br. 24 (quoting *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir.) (Friendly, J.), cert. denied, 469 U.S. 884 (1984)). The contention that Section 10(b) prohibits only affirmative misrepresentations or material omissions that pertain to the securities themselves finds no support in the text of the "in connection with" requirement and is refuted by this Court's decisions in *O'Hagan* and *Bankers Life*. See Gov't Br. 39-41. The deception in *O'Hagan* pertained to the fiduciary's loyalty to his principal, not to any attributes of the securities that he purchased. 521 U.S. at 652. And the deception in *Bankers Life*, like one of respondent's deceptions here, pertained to the fiduciaries' intent to misappropriate the proceeds of the transaction, not to any attributes of the securities that were sold. 404 U.S. at 9. Respondent's proposed limitation on the scope of Section 10(b) would undermine the securities laws, because it would exclude from the statute's scope many pernicious forms of fraud, including frauds by brokers that the

courts of appeals have uniformly held are covered. See Gov't Br. 41-43.

Indeed, even the Second Circuit's decision in *Chemical Bank* did not hold that the deception must "pertain to the securities themselves" in the narrow sense that respondent urges. See 726 F.2d at 943-944 & n.24 (distinguishing, *inter alia*, *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967) (discussed at Gov't Br. 13, 40)).[3] And, in subsequent decisions, the Second Circuit has found actionable under Section 10(b) fraud that relates to the consideration for the sale, which would not be encompassed by the narrow interpretation of the "in connection with" requirement that respondent seeks to draw from *Chemical Bank*. See *SEC* v. *Drysdale Sec. Corp.*, 785 F.2d 38 (2d Cir.) (misrepresentations about financial condition of broker-dealer were actionable under Section 10(b) where they directly related to broker-dealer's ability to carry out its obligations to repurchase securities), cert. denied, 476 U.S. 1171 (1986); see also *Press* v. *Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537 (2d Cir. 1999) (rejecting position that omission that "did not pertain to the security itself nor to its value * * * was not 'in connection with' the sale"). Respondent's fraudulent sales of securities for his own benefit and his subsequent

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[3] The import of *Chemical Bank* is further clouded by the fact that the court at one point described its holding as being that the plaintiff "failed to establish the 'loss causation' necessary for a legally sufficient claim under § 10(b)." 726 F.2d at 943 n.23. The court apparently confused the requirement that a private plaintiff seeking damages show that the defendant's deception caused him a loss with the "in connection with" requirement. The "in connection with" requirement, which applies to all litigants, including the government, is, however, "analytically distinct" from the "loss causation" requirement, which applies only to private plaintiffs who seek damages. 8 Loss & Seligman, *supra*, at 3686. Fraud may occur "in connection with" a securities transaction even when it does not "cause [the] specific injury or loss" alleged. *Ibid.*

embezzlement of the proceeds thus violated Section 10(b) under Second Circuit precedent because they involved fraud concerning the consideration (*i.e.*, the proceeds) that the Woods' were to receive from the sales.

b. Respondent also incorrectly contends (Br. 25-26) that his embezzlement of the proceeds of the securities sales was not "in connection with" the sales because he had discretionary trading authority. A stockbroker is not granted immunity from Section 10(b) because his customers give him discretionary authority to handle their investments. Indeed, discretionary authority has the opposite effect, because it establishes the broker's status as fiduciary and his consequent continuing duty to disclose actions contrary to the customers' interests, including his diversion of sales proceeds from his customers to himself. See pp. 1-2, *supra*. Respondent's contrary theory would leave unprotected those brokerage customers most in need of protection. See Gov't Br. 30.

Respondent relies on two Seventh Circuit cases. Br. 26 (citing *O'Brien* v. *Continental Illinois Nat'l Bank & Trust Co.*, 593 F.2d 54 (1979); *Congregation of the Passion, Holy Cross Province* v. *Kidder Peabody & Co.*, 800 F.2d 177 (1986)). *O'Brien* is inapposite because it concerned whether an implied private right of action should be recognized under the circumstances—a question that may be informed by "policy considerations," *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975)—rather than (as here) whether Section 10(b) prohibits the conduct at issue, which is resolved by the statutory text and purposes. *Congregation of the Passion* essentially followed *O'Brien*. Moreover, to the extent that those Seventh Circuit decisions concerned the scope of Section 10(b) itself, their reasoning cannot be reconciled with this Court's subsequent decision in *O'Hagan* (or, as explained below, with the Seventh Circuit's recognition that churning violates Section 10(b)). The Seventh

Circuit reasoned in *O'Brien* that a client who has given an agent discretionary authority to invest cannot sue under Section 10(b) for fraudulent breaches of the agent's fiduciary duty because those breaches do not induce the client to make any investment decision and enforcement of fiduciary duties is a concern of state law. See 593 F.2d at 60, 63. In *O'Hagan*, however, the deception was the fiduciary's pretense of loyalty to his principal while he acted contrary to his fiduciary duty, 521 U.S. at 652, and that deception did not induce any investment decision by the principal. Indeed, the principal, unlike the Woods here, was not even a party to the relevant securities trades.

Respondent's contention based on the discretionary nature of the Woods' account is also contradicted by his concession (Br. 34) that "churning" violates Section 10(b). "Churning occurs when a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business." *Ibid.* (quoting 8 Loss & Seligman, *supra*, at 3874). A required element of a churning claim is that the alleged wrongdoer controlled trading in the account. See *Armstrong* v. *McAlpin*, 699 F.2d 79, 90 (2d Cir. 1983); *Costello* v. *Oppenheimer & Co.*, 711 F.2d 1361, 1368 (7th Cir. 1983); *Carras* v. *Burns*, 516 F.2d 251 (4th Cir. 1975). The requisite "[c]ontrol is clearly established where the account is discretionary, a power of attorney has been executed in favor of the broker, and the trades completed without prior approval by the customer." *Costello*, 711 F.2d at 1368; 8 Loss & Seligman, *supra*, at 3877. Although respondent concedes that churning is covered by Section 10(b), he never explains how that concession is consistent with his position that his conduct is not covered.

c. Respondent's attempt to distinguish *Bankers Life* fails for similar reasons. As respondent acknowledges (Br. 27, 29), the Court held in *Bankers Life* that the "in connection with" requirement was satisfied when corporate insiders

induced the corporation to sell its securities by "dup[ing] [it] into believing that it, the seller, would receive the proceeds." 404 U.S. at 9. Respondent argues that *Bankers Life* differs from this case because "the seller 'needed to authorize the sale in *Bankers Life*' and was deceived into doing so," Resp. Br. 28 (quoting Gov't Br. 30), but respondent "could buy or sell securities for the Woods' account without obtaining specific authorization for each transaction" (*ibid.*). Respondent's proffered distinction thus relies on his untenable theory that a stockbroker's possession of discretionary authority insulates the broker from any claim that he has defrauded his customers in violation of Section 10(b). Respondent also ignores the fact that his failure to disclose his plans and actions deprived the Woods of the opportunity to prevent his sales of their securities. His deception was thus instrumental to those sales, just as the misrepresentation in *Bankers Life* was instrumental to the sale in that case.[4]

3. The "In Connection With" Requirement Is Satisfied Because Respondent's Deception And Securities Sales Were Integral Parts Of The Same Fraudulent Scheme

a. Contrary to respondent's contention, the Court need not decide in this case the question whether "all broker conversions of client funds or securities violate § 10(b)." Resp. Br. 9. Respondent did much more than just convert customer assets, and the Court can conclude that he violated Section 10(b) and Rule 10b-5 without deciding that every stockbroker conversion of customer assets violates those

[4] Respondent correctly disclaims (Br. 28-29) any distinction based on the fact that the defendants in *Bankers Life* made an affirmative misrepresentation while respondent's deception involved material omissions. Any such distinction is unsupportable. See Gov't Br. 30.

provisions. Respondent fraudulently sold securities, which he had promised to buy and sell for the benefit of his customers, for the secret purpose of misappropriating the proceeds, and then fraudulently embezzled the proceeds as he had planned. Both frauds were "in connection with" the securities sales because the frauds and the sales were integral parts of the same scheme.[5]

b. Respondent argues that the "in connection with" language requires that the fraud "pertain to" (Br. 11), be "part of," or "affect" a securities transaction (Br. 12), or that there be "a close" or "direct link" (Br. 13) between the fraud and the transaction. Those suggested criteria are satisfied here. Respondent's fraud "pertain[ed] to," was "part of," and "affected" the sales both because the sales, secretly made for his own benefit, were fraudulent, and because the proceeds were diverted to respondent in furtherance of his fraudulent scheme rather than transmitted to the Woods, who ended up with nothing in return for the securities that they sold. It is hard to imagine a more "direct link" between fraud and securities sales than when the sales were a fraud on the seller,

[5] Respondent erroneously suggests (Br. 8, 40, 41) that the sales were not integral to his scheme because he was in a position to embezzle the Woods' money before investing it in securities. Because respondent in fact sold securities to effect his fraud, see Pet. App. 28a-29a, he cannot escape responsibility by establishing that he could have used other means. The complaint alleges that respondent began his scheme several months *after* the Woods opened the account, by which time he presumably had invested their money. See *id.* at 27a-28a (account was opened "[i]n September 1987," and respondent's "fraudulent scheme began in May 1988, shortly after Wood was hospitalized as a result of his stroke," when respondent embezzled $41,000 by selling mutual fund shares). Respondent could not, in any event, have misappropriated all of the Woods' assets without selling securities, because the Woods entrusted him with not only cash but also a bond worth more than $200,000. See 7 Tr. 178-179, *United States* v. *Zandford*, Crim. No. WN-94-0165 (D. Md. July 18, 1995) (respondent's testimony).

were made with the fraudulent intent to embezzle the proceeds, and were necessary to generate the funds that were then embezzled.

Respondent is mistaken, however, in his restrictive glosses on the phrase "in connection with the purchase or sale of any security." Neither of the books on English grammar that he cites supports his narrow reading. One generally describes the role of prepositions, B. & C. Evans, *A Dictionary of Contemporary American Usage* 386-388 (1957), and the other condemns the phrase "in connection with" as "flabby English," and states that "vagueness and pliability [are] its only merits." H.W. Fowler, *A Dictionary of Modern English Usage* 105 (2d ed. 1965). A "connection" is a "junction," "union," or "relationship." *Webster's New International Dictionary* 565 (2d ed. 1934). Thus, the plain meaning of "in connection with" supports the SEC's position that the requirement is met when the fraud and the purchase or sale are joined or related to one another in the same fraudulent course of conduct—"when the proscribed conduct and the sale [or purchase] are part of the same fraudulent scheme." Gov't Br. 19 (quoting *Alley* v. *Miramon*, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980) (Wisdom, J.)).[6]

Respondent quibbles (Br. 30) that "the SEC has read too much into" this Court's description, in its unanimous opinion in *Bankers Life*, 404 U.S. at 12-13, of the "in connection with" clause as encompassing all fraud "touching" a securities trans-

[6] Respondent contends that the SEC's interpretation of the "in connection with" requirement means that Section 10(b) "would apply to an employee who stole stock certificates from his or her employer and sold them." Br. 34. The SEC's interpretation would indeed cover an employee, such as a pension fund manager, who, while secretly intending to misappropriate the proceeds, sold securities that the employer had entrusted to him to manage. It would not, however, cover an employee who stole stock certificates from his or her employer and sold the stock if there was no deception involved.

action. See also *Santa Fe*, 430 U.S. at 475-476. The SEC, however, relies on *Bankers Life*'s use of "touching" for the very purpose that respondent concedes it was intended—"to highlight the breadth the case advocated in interpreting the requirement." See Resp. Br. 31 (quoting *In re Ames Dep't Stores Inc., Stock Litig.*, 991 F.2d 953, 964 n.5 (2d Cir. 1993)).

Respondent similarly errs in contending that the SEC improperly "equates the purposes of § 10(b) with the broad purpose of pervasive securities industry regulation." Br. 19; see Br. 14 n.7. Rather, the SEC follows the principle respondent advocates elsewhere of "us[ing] the purposes of the statute to discern" the meaning of the "in connection with" requirement. Br. 32 n.27. This Court has likewise construed Section 10(b) in light of the purposes underlying the Exchange Act, including the goal of "insur[ing] honest securities markets and thereby promot[ing] investor confidence." See *O'Hagan*, 521 U.S. at 658. It is consistent with those purposes to construe Section 10(b) to encompass respondent's conduct, because to exclude it would erode honesty and investor confidence in the securities markets, in contravention of core purposes of the Act. See Gov't Br. 24-28.

c. Respondent also contends (Br. 14-20, 32-34) that Section 10(b) does not apply to his fraudulent conduct because Section 10(b) covers only "new" forms of fraud (Br. 18) and the conduct in which he engaged does not in any event impair "market integrity or investor understanding" (Br. 19). Respondent's contention that Section 10(b) excludes traditional forms of fraud has no grounding in the text of Section 10(b) and is contradicted by precedent. This Court has repeatedly held that Section 10(b) prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Bankers Life*, 404 U.S. at 11 n.7. Section 10(b) is a "catch-all"

provision intended to reach all fraud connected with securities transactions. See, *e.g.*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (1976). Thus, respondent's embezzlement is not excluded from Section 10(b)'s purview because it is a well-recognized form of fraud. See *O'Hagan*, 521 U.S. at 654.

Moreover, stockbroker embezzlement of customer securities and securities proceeds does threaten both "market integrity" and "investor understanding" (Resp. Br. 19). Investor understanding suffers when a stockbroker deceives investors into believing that he is undertaking securities transactions for their benefit and that they will re ive the proceeds of the transactions. See Resp. Br. 33 & n.29 (explaining *Bankers Life* as a case in which fraud impaired investor understanding because the seller was duped into believing it would receive the proceeds). And the integrity of the markets is called into question when a stockbroker engages in conduct that violates the "high standard of business ethics in the securities industry" that Congress sought to achieve through the securities laws. *Basic Inc.* v. *Levinson*, 485 U.S. 224, 234 (1988).

d. Respondent appears to contend (Br. 13-22) that the SEC lacks authority to sanction stockbrokers for violations of Section 10(b)—at least for the type of fraud involved in this case—because Congress gave "primary responsibility" (Br. 15) for broker regulation to industry self-regulatory organizations, such as the National Association of Securities Dealers (NASD). On the contrary, the Exchange Act gives the SEC direct authority to bring both injunctive actions and administrative proceedings against stockbrokers who commit fraud in connection with securities transactions, and the rules of the SEC and self-regulatory organizations are complementary rather than mutually exclusive. Section 10(b) makes it unlawful for "any person" to use fraud in connection with the trading of securities, and Section 21(d)(1), 15 U.S.C. 78u(d)(1), authorizes the SEC to bring an action in court

when it appears that "any person" is violating the Act. Further, the SEC may bring administrative proceedings against brokerage firms and their personnel and impose remedial sanctions on them under Section 15(b)(4) and (6), 15 U.S.C.78*o*(b)(4) and (6), and Section 21C, 15 U.S.C. 78u-3. Gov't Br. 28 n.9. The availability of disciplinary action by self-regulatory organizations does not restrict the SEC's authority to act against brokers who violate the securities laws. The SEC has taken sueh actions against brokers since shortly after enactment of the Exchange Act. Indeed, the first published adjudicatory decision of the SEC interpreting Section 10(b) to cover the sort of fraudulent conduct at issue in this case arose from an administrative proceeding brought by the SEC under Section 15(b). See *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947).[7]

Thus, contrary to respondent's contention, the Act provides for "direct governmental regulation" (Br. 16) of matters covered by Section 10(b)—apart from any authority the NASD and the exchanges have to discipline their members. As this Court has recognized, many provisions of the federal securities laws overlap in coverage. In *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 468-469 (1969), for example, the Court rejected the argument that Section 10(b) "does not cover misrepresentations which occur in connection with proxy solicitations" because Section 14 of the Exchange Act regulates proxy solicitations. The Court observed that "[t]he fact that there may be some overlap" between Section 10(b) and Section 14 "is neither unusual nor unfortunate."

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[7] *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963), on which respondent relies (Br. 10, 15-16, 21), is inapposite. In *Silver*, the Court discussed the role of the exchanges in determining "whether and to what extent the federal antitrust laws apply to securities exchanges regulated by the * * * Exchange Act." 373 U.S. at 342. The Court in no way suggested that the powers of self-regulatory organizations implicitly limit the SEC's authority to enforce the securities laws.

Ibid. See also *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 383 (1983) (noting that same fraudulent conduct was proscribed by both Section 17(a) of Securities Act of 1933 and Section 10(b)).

For similar reasons, respondent is not aided (Br. 13) by Section 15(b)(4)(B) of the Exchange Act, 15 U.S.C. 78*o*(b)(4)(B), which specifies the types of criminal convictions that may form the basis for SEC sanctions against broker-dealers, and lists separately crimes "involv[ing] the purchase or sale of any security" (in subparagraph (i)) and crimes involving the "fraudulent conversion, or misappropriation of funds, or securities" (in subparagraph (iii)). There is substantial overlap among the descriptions of a number of the crimes covered by Section 15(b)(4)(B). Compare, *e.g.*, 15 U.S.C. 78*o*(b)(4)(B)(i) (covering crimes involving "taking of a false oath, the making of a false report, bribery, [or] perjury") with U.S.C. 78*o*(b)(4)(B)(iv) (covering violations of 18 U.S.C. 152, which criminalizes those actions in bankruptcy proceedings), and 15 U.S.C. 78*o*(b)(4)(B)(i) (covering crimes involving "the purchase or sale of any security") with 15 U.S.C. 78*o*(b)(4)(B)(ii) (covering crimes arising out of conduct of the business of a broker or dealer). Thus, subparagraph (iii)'s reference to crimes involving "fraudulent conversion * * * of funds, or securities," does not imply that some such crimes are not also encompassed by subparagraph (i)'s reference to crimes involving "the purchase or sale of any security."

In any event, Section 15(b)(4)(B) applies only to broker-dealers, and subparagraph (iii) was adopted as an amendment to the Exchange Act in 1964. See Pub. L. No. 88-467, 78 Stat. 571. The fact that Congress, when it amended Section 15(b) in 1964, listed crimes involving fraudulent conversion of securities or funds separately from crimes involving the purchase or sale of any security does not suggest that, when an earlier Congress enacted Section 10(b) in 1934,

it intended to exclude fraudulent conversion of securities or proceeds from the coverage of that catch-all antifraud provision, which applies to "any person."

4. The SEC's Longstanding Interpretation Of Section 10(b) And Rule 10b-5 Is Entitled To Deference

Respondent mistakenly contends (Br. 42-48) that the SEC's interpretation of Section 10(b) and Rule 10b-5 is not entitled to deference. As our opening brief explains (at 37-39), Section 10(b) contains "an express delegation of authority to the [SEC] to elucidate" Section 10(b) through "rules and regulations," and the Exchange Act authorizes the SEC to interpret the Act (including Section 10(b)) through "formal adjudication." *United States* v. *Mead Corp.*, 121 S. Ct. 2164, 2171, 2173 (2001); 15 U.S.C. 78j(b), 78o(b)(4)(D) and (6)(A)(i). Under *Chevron U.S.A. Inc* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), as clarified in *Mead*, the SEC's interpretation of Section 10(b) and Rule 10b-5, expressed in its published adjudicatory opinions such as *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947), is "binding in the courts unless * * * manifestly contrary to the statute." 121 S. Ct. at 2171. The SEC's longstanding interpretation is also entitled to considerable weight under deference principles that predate *Chevron* and *Mead*. See Gov't Br. 38-39 (citing, *inter alia*, *Norwegian Nitrogen Prods. Co.* v. *United States*, 288 U.S. 294, 315 (1933)).

a. There is no merit to respondent's suggestion (Br. 43, 44, 45) that the SEC has somehow waived its deference argument because it has not previously sought or received *Chevron* deference in this Court's Section 10(b) cases. Congress has granted the SEC authority to take "administrative action with the effect of law." *Mead*, 121 S. Ct. at 2172. That authority cannot have been surrendered by the SEC's litigation decisions not to rely on it in previous cases. Indeed, many of those cases (unlike this one) involved SEC inter-

pretations of Section 10(b) that were not embodied in formal adjudications, *e.g.*, *O'Hagan*. Moreover, the Court has deferred to the SEC's interpretation of Section 10(b) on at least one occasion, albeit without specifying the kind of deference that the Court was applying. See *Basic Inc.*, 485 U.S. at 239 n.16 (giving SEC's interpretation "due deference").

b. Respondent incorrectly suggests (Br. 44) that the Court decided in *O'Hagan* that no deference is due the SEC's interpretations of Section 10(b). *O'Hagan* does not address that question. The passage in *O'Hagan* on which respondent relies simply observes that, under Section 14(e) of the Exchange Act, the SEC is empowered to adopt prophylactic rules that proscribe "more than the core activity prohibited" by the statute, but, under Section 10(b), any implementing rule may proscribe "only conduct that § 10(b) prohibits." 521 U.S. at 673 & n.18.

Adams Fruit Co. v. *Barrett*, 494 U.S. 638 (1990) (Resp. Br. 42, 44), is also inapposite. There, the Court declined to defer to the Secretary of Labor's position that there was no private right of action under the Migrant and Seasonal Agricultural Workers Protection Act. The Court reasoned that, although the Act authorized the Secretary to promulgate standards of conduct, it entrusted administration of the private action provisions to the courts and did "not empower the Secretary to regulate the scope of the judicial power vested by the statute." 494 U.S. at 650. Here, in contrast, Congress has expressly empowered the SEC to administer the Exchange Act and to interpret Section 10(b), including its "in connection with" language.

c. Respondent also incorrectly asserts (Br. 44) that the SEC's interpretation is not entitled to deference because violations of Section 10(b) may give rise to criminal or other "non-SEC initiated" actions. This case does not involve the scope of the implied private right of action under Section

10(b), and the SEC's position here does not depend on any entitlement to deference concerning the scope of those actions. Judicial inference of a private right of action should not reduce the deference given to decisions made pursuant to interpretive authority expressly delegated by Congress. Further, although willful violations of Section 10(b) and Rule 10b-5 are criminal, 15 U.S.C. 78ff(a), interpretations of a statute and its implementing regulations by the agency charged with their administration are entitled to deference even when the statute contains criminal penalties. See *Babbitt* v. *Sweet Home Chapter of Communities For a Great Oregon*, 515 U.S. 687, 703-704 & n.18 (1995). Once an agency has issued an interpretation that particular conduct is proscribed, a criminal defendant cannot plausibly argue that he did not have reasonable notice of the interpretation. That is particularly true here, because the SEC's interpretation is longstanding and consistent.

d. Finally, there is no basis for respondent's contention (Br. 45-48) that the SEC's decisions do not warrant *Chevron* deference because they contain insufficient legal analysis. As an initial matter, the decisions contain ample legal analysis. See Gov't Br. 35-36 (summarizing analyses of *Kenneth Leo Bauer*, 26 S.E.C. at 770, and *Southeastern Sec. Corp.*, 29 S.E.C. 609 (1949)). In any event, there is no requirement that agency opinions in formal adjudications contain a certain amount or form of legal analysis in order to merit *Chevron* deference. The opinions warrant deference not because of the persuasiveness of their legal reasoning, cf. *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 140 (1944), but because they are "promulgated in the exercise" of "delegated authority * * * to make rules carrying the force of law." *Mead*, 121 S. Ct. at 2171; see *Martin* v. *OSHRC*, 499 U.S. 144, 157 (1991) (deferring to interpretation by Secretary of Labor reflected in citation that triggers proceedings before OSHRC). Although respondent refers to the SEC opinions

as "public announcements" (Br. 45) and cites the releases that described them (Br. 46) rather than their citations in the S.E.C. Decisions and Reports, they are official SEC opinions that resolve formal adjudications conducted in accordance with the procedures specified in 5 U.S.C. 554, 556 and 557. They are thus the product of "a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement" that "carr[ies] the force of law," and they are entitled to that weight. *Mead*, 121 S. Ct. at 2171.

* * * * *

For the foregoing reasons, and the reasons stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

PAUL D. CLEMENT
Acting Solicitor General[*]

MARCH 2002

[*] The Solicitor General is recused in this case.

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No.01-147

Supreme Court, U.S.
FILED
DEC 26 2001
OFFICE OF THE CLERK

IN THE
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v.

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BRIEF *AMICI CURIAE* OF AARP, NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS, AND CONSUMER FEDERATION OF AMERICA IN SUPPORT OF PETITIONER

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BRIEF *AMICI CURIAE* OF AARP, NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS, AND CONSUMER FEDERATION OF AMERICA IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE*[1/]

AARP is a non-profit, non-partisan organization with more than 35 million members, dedicated to addressing the needs and interests of Americans aged 50 and older. As the largest membership organization representing the interests of older Americans, AARP is very concerned about fraudulent

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[1/] The parties' consents have been filed with the Clerk of the Court. *Amici curiae* state that no counsel for any party authored this brief in whole or in part and that no party other than these *amici curiae*, their members or counsel made a monetary contribution to the preparation or submission of this brief.

practices in the securities industry. Older people are frequent targets of fraud because they often have significant assets and are looking for investment opportunities that will supplement the Social Security and pension benefits they will receive during retirement. As a result, AARP has made the need to combat securities fraud a high priority, with a particular focus on stockbroker practices that are inconsistent with an investor's best interests. AARP has been very involved in commenting on legislative and regulatory proposals that address such practices, has filed *amicus curiae* briefs in cases involving interpretation of the federal securities laws, e.g., *Kauthar Sdn Bhd v. Sternberg*, No. 98-799 (U.S. Supreme Court Dec. 17, 1998) (in support of petition for writ of *certiorari*); *Newton, et al. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., et al.*, No. 96-5045 (3d Cir. July 17, 1997) (in support of petition for rehearing with suggestion for rehearing *en banc*), and has opposed efforts to limit federal statutory remedies that allow defrauded investors to obtain financial redress. In addition, AARP has undertaken efforts to combat investors' low financial literacy and to educate them about how to choose financial professionals who will act in their best financial interest. For example, in 1998 AARP commissioned a survey of people 50 and older to determine investor awareness of broker compensation practices. The survey revealed that investors do not have a basic understanding of the conflicts of interest that may arise because of such practices, such as sales contests and higher commissions for the sale of proprietary products. AARP, Investor Awareness of Broker Compensation Practices: Findings From An AARP Survey 3-4 (Apr. 1998) (on file with AARP); *see also* AARP, Investor Understanding of Broker Account Statements: Findings From a Survey 5-6, *available at* http://research.aarp.org/consume/broker.pdf (Oct. 2000) (revealing that experienced investors with full-service brokerage accounts do not understand much of the information on typical account statements, including basic terms such as "equity," or fundamental transactions, such as the number of shares reinvested in a particular fund).

The National Association of Securities and Commercial Law Attorneys ("NASCAT") is an association of law firms

and attorneys who litigate antitrust, commercial, consumer, securities fraud, and shareholder derivative cases in federal and state courts throughout the country. NASCAT and its members are devoted to representing victims of corporate abuse, fraudulent schemes, and so-called "white-collar" criminal activity in cases that have the potential for advancing the state of the law, educating the public, modifying corporate behavior, and/or improving access to justice and compensation for the wrongs inflicted upon victims. NASCAT advocates principled interpretation and application of federal and state securities laws to protect investors from manipulative, deceptive, and fraudulent practices and to ensure that the nation's securities markets operate fairly and efficiently. NASCAT's members frequently represent victims of securities fraud in cases brought under federal and state securities laws and thus have an interest in the effective private enforcement of these laws.

The Consumer Federation of America ("CFA") is a non-profit association organized in 1968 to advance the interests of consumers through advocacy and education. CFA's membership is comprised of 285 national, state, and local consumer groups throughout the United States which, in turn, represent more than 50 million consumers. Recognizing the growing participation of American consumers in our nation's financial markets, CFA has made protecting the interests of individual investors a priority. The guiding principles behind CFA's work on these issues is that investors deserve effective protection from fraud, fair dealing from financial professionals, and full and timely disclosure of information relevant to their interests. In keeping with these concerns, CFA has supported federal and state legislative and regulatory initiatives on a broad array of investor protection issues, including financial planner regulation, penny stock fraud, rights to redress for victims of securities fraud (both in court and through arbitration), industry compensation practices, and plain language disclosures.

The interest of *amici* in this case stems from their positions among the leading consumer organizations in this country involved in matters that concern protecting investors

from fraud and the substantial interests at stake for their members and the consumers they serve. *Amici* submit this brief to apprise the Court of the unprecedented degree to which Americans are investing in the securities markets and their relatively low level of understanding of how the markets operate, and to more fully explain the effect the Fourth Circuit's erroneous interpretation of the "in connection with" requirement will have in undermining securities law enforcement and the protections currently afforded investors and the national securities markets by the anti-fraud provisions of § 10(b) of the Securities Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78j(b) (2001), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001), promulgated by the Securities and Exchange Commission ("SEC").

SUMMARY OF ARGUMENT

The Fourth Circuit erred in holding that "Zandford's fraudulent actions were not sufficiently connected with a securities transaction" to support an SEC enforcement action under the federal securities laws. *SEC v. Zandford*, 238 F.3d 559, 561 (4th Cir. 2001), *cert. granted*, 2001 U.S. LEXIS 10303 (Nov. 8, 2001). Not only did the lower court misread the plain language of the Exchange Act and Rule 10b-5, it also misapplied this Court's precedent. The importance of the Court correcting the Fourth Circuit's error cannot be overstated.

In recent years, Americans have entered our nation's securities markets in record numbers, many for the first time. This is due, in large part, to the recognition that individuals have to plan and provide for their retirement security, with less reliance on Social Security and traditional employer-sponsored defined benefit pension plans. Yet, many investors are ill-equipped to navigate the complexities of the markets and thus rely on the advice of a range of professionals, including stockbrokers and financial planners. In placing their trust in others they are, in many instances, unwittingly placing their financial security in jeopardy. When the worst happens, and their trust is abused through fraud, individual investors need access to the full range of legal enforcement

mechanisms and remedies – federal and state, public and private, civil and criminal – that Congress and state legislatures have enacted for their protection.

Unless the Court reverses the Fourth Circuit and upholds the standard intended by Congress and advanced by Petitioner America's individual investors and their financial futures will remain at the mercy of unscrupulous practitioners. At the same time, the SEC's civil enforcement authority and the ability of individual investors to seek redress will be severely circumscribed. The result will be the severe dilution of two powerful weapons in the full arsenal of legal protections intended to benefit investors.

ARGUMENT

I. INTRODUCTION

A. Individuals Are Investing in the Securities Markets in Unprecedented Numbers, Often For the First Time

Demographic factors have led to considerable changes in participation in this country's securities markets. In the past, wealthy individuals and corporations were the primary investors in the stock market. That is no longer true, due to the combined effect of the baby boom generation's entry into adulthood, changes in retirement regulations and strategies, and a stock market that, for the most part, has been producing incredibly high returns. The nation has entered a period in which Social Security provides proportionately less of needed retirement income, and traditional employer-sponsored defined benefit pension coverage has decreased. In addition, Americans have departed, in unprecedented numbers, from their historic practice of placing primary reliance on federally-insured products, such as savings accounts and certificates of deposit, for their retirement needs.

A recent Investment Company Institute (ICI)[2/] survey of the mutual fund industry showed that the combined assets of the nation's mutual funds totaled $6.616 trillion in October 2001. Investment Company Institute, Mutual Funds Facts & Figures, Current Statistical Releases, Trends in Mutual Fund Investing, *available at* http://www.ici.org/facts_figures/trends_1001.html (Nov. 29, 2001). The ICI also indicates that as of May 2001, an estimated 93 million individuals in 54.8 million American households, or 52% of all U.S. households, owned mutual funds. Mutual fund ownership among U.S. households increased steadily during the 1990s and, in 2000, one out of three individuals in the country owned mutual funds. Investment Company Institute, About Mutual Fund Shareholders, Demographic Information, Frequently Asked Questions About Mutual Fund Shareholders (Nov. 2001) [hereinafter Frequently Asked Questions] *available at* http://www.ici.org/aboutshareholders/shareholders_faqs.html.

The increased number of individuals making mutual fund purchases is due, in large part, to the significant trend toward replacing defined benefit pension plans with defined contribution plans. The ICI reported that 62% of fund shareholders own funds through defined contribution retirement plans. *Id.*; *see also* Office of Investor Education and Assistance, SEC, The Facts on Saving and Investing 6 (Apr. 1999) [hereinafter SEC, The Facts on Saving and Investing]. This increased reliance on defined contribution plans places significant responsibility on individuals to make appropriate investment choices so they will have adequate retirement income. When mutual fund assets typically represent 40% of household assets, ICI, Frequently Asked Questions, *supra*, investors face a heightened risk if they incur losses due to bad advice, abusive practices, or fraud. The potential for fraud and other abuses becomes even greater

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[2/] The Investment Company Institute is the national association of the American investment company industry. Founded in 1940, its membership includes 8,710 mutual funds, 481 closed-end funds, and 7 sponsors of unit investment trusts.

as large numbers of first-time investors enter the securities markets and, due to their relative lack of sophistication and high financial illiteracy, rely on a range of professionals, including stockbrokers and financial planners, to advise them in the purchase or sale of securities.

B. Individual Investors Have Extremely Low Levels of "Financial Literacy" Leading Them to Rely Heavily on Financial Professionals

The complexity of the marketplace and the relative lack of sophistication of a majority of individual investors combine to hinder their ability to make wise investment decisions. "America faces a financial literacy crisis. At a time when more Americans than ever before are investing in our securities markets through the purchase and sale of stocks, bonds, and mutual funds, numerous studies show they lack the financial basics." SEC, The Facts on Saving and Investing, *supra*, at 2.

Then-SEC Chairman Levitt stated that

> [t]ens of millions of Americans lack the basic saving and investing information they need to prepare for retirement or to meet other financial goals. . . . While 63 percent know the difference between a halfback and a quarterback, only 12 percent know the difference between a load and a no-load mutual fund.

Arthur Levitt, Expanding the Promise of Opportunity and Security Through Savings and Investing, Remarks Before the Consumer Federation of America, *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch229.htm (Dec. 3, 1998).

Several recent studies conducted by government agencies, financial services corporations, and non-profit organizations have produced remarkable findings that bear out Chairman Levitt's concerns. The studies took different approaches but

reached the same conclusion: individual investors lack even the most rudimentary knowledge needed to make informed investment decisions. Investors do not know the basics of how investments work, and they do not even know what they are doing with their own money. For example, a May 1996 study conducted by the National Association of Securities Dealers (NASD) found that while 78% of Americans can name a character on a television sitcom, a mere 14% know the difference between growth and income stocks. Press Release, National Association of Securities Dealers, Inc., NASD Launches Major Public Disclosure, Investor Education Initiative (Feb. 19, 1997) (on file with AARP); *see also* Ruth Simon, *We Put Investors to the Test -- and, Boy, Did They Ever Flunk*, Money, Mar. 1998, at 37 (reporting on results of MONEY/Vanguard Mutual Fund Literacy Test on which mutual fund investors scored an average of just 51 out of 100); Towers Perrin, Preparing For Retirement: A Survey of 1,000 Working Americans 9 (Feb. 1995) (one-third of those who participate in a 401(k) or other retirement savings plan think there is no risk associated with bonds, and 14% think there is no risk associated with an investment in a "mutual fund" or a "balanced" fund) (reports on file with AARP).

Unfortunately, these findings have not improved with time. The Securities Investor Protection Corporation and the National Association of Investors Corporation recently reported that 85% of American investors do not know enough to pass a "survival" quiz designed to assess their knowledge of what to do in times of market downturns and other financial difficulties. For example, almost two in three investors do not know the first step to take when they suspect they are dealing with a problem broker, and fewer than one in five knows there is no insurance for stock market losses. Press Release, Securities Investor Protection Corporation & National Association of Investors Corporation, Survey: More Than 4 Out of 5 U.S. Investors Fail Quiz of Basic "Survival" Knowledge, *available at* http://216.181.142.217/sipc/release0.html (Aug. 1, 2001).

The only conclusion to be drawn from this sampling of findings is that individual investors do not know the ABCs of investing. Lacking this basic knowledge of how the securities markets operate, and being unaware of the fundamental features of their own investments, individual investors rely in large measure on third parties, such as brokers, for advice on the purchase and sale of securities. More than 80% of new mutual fund purchases were made through intermediaries such as brokers, banks, financial planners, insurance agents, and employers,[3/] and 37% of shareholders purchase funds primarily through full-service brokers, insurance agents, financial planners, or bank representatives. ICI, Frequently Asked Questions, *supra*. In spite of this, almost four-fifths (79%) of investors feel it is difficult to know how to choose a good professional investment advisor. SEC, The Facts on Saving and Investing, *supra*, at 24. And, the vast majority of investors (88%) who have received advice from a financial professional have never looked into the disciplinary history of their broker or financial planner. Press Release, Investor Protection Trust, National Association of Securities Dealers, North American Securities Administrators Association, Survey: Financial Illiteracy, Bad Habits Dangerous Mix For Investors, *available at* http://www.investorprotection.org/nr1.htm (May 14, 1996). Individual investors' lack of knowledge about the securities markets, their own investments, and how to choose trustworthy financial professionals place these investors at great risk of being defrauded by unscrupulous practitioners.

[3/]Nearly half (48%) of mutual fund shareholders identified an employer-sponsored retirement plan as their primary method for purchasing mutual funds, and 57% bought their first fund through these plans. ICI, Frequently Asked Questions, *supra*.

II. THE PREVALENCE OF SECURITIES FRAUD REQUIRES THAT THE SEC & INVESTORS HAVE A FULL RANGE OF STRONG, FLEXIBLE ENFORCEMENT TOOLS.

A. Securities Fraud Continues to Plague Investors

"We are living in a time when the stock market is more a part of the American consciousness than ever before." SEC Chairman Arthur Levitt, Remarks to National Press Club, Plain Talk About On-line Investing (May 4, 1999).[4/] Thus, protection against fraud is more important than ever. State regulators estimate that securities fraud costs Americans billions of dollars each year. Press Release, North American Securities Administrators Association, "Top 10 Investment Scams" List Released by State Securities Regulators, *available at* http//www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=156 (Apr. 23, 2001). The excesses of the 1980s, which gave rise to spectacular failures of financial firms,[5/]

[4/] The stock market has been characterized by one commentator as a kind of magic. "Investors pay enormous amounts of money for completely intangible rights whose value depends entirely on the quality of the information that investors receive and the honesty of other people about whom investors know almost nothing. This magic does not appear in unregulated markets." Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 Bus. Law. 1565, 1565 (Aug. 2000).

[5/] The highest-flying investment banking firm of the 1980s, Drexel Burnham Lambert pled guilty to federal felony securities fraud charges and paid $650 million in fines and sanctions. *SEC v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989) (reflecting entry of consent decree).

junk bonds,[6/] and the collapse of the thrift industry,[7/] threatened a loss of investor confidence in the financial markets with a corresponding negative impact on the ability of business to raise capital. Such apprehensions, however, gave way to the exuberance of the 1990s and the charging bull market that marked the turn of this century. New and enthusiastic investors entered the financial markets[8/] and, as could be expected, those so inclined found new and enthusiastic ways to give honesty the slip and defraud investors.

As Chairman Levitt also observed:

> With this vast expansion in our markets and in public participation in those markets, we would expect to see an increase in the incidence of fraud. We have particularly seen

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[6] The most notorious "financier" of the 1980s, Michael Milken, the "junk bond king," was indicted on 98 counts of RICO and criminal securities fraud, pled guilty to six counts and was sentenced to ten years in prison. *SEC v. Milken*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,200 (S.D.N.Y. Apr. 24, 1990) (reflecting settlement of civil enforcement action and guilty plea).

[7] President George H. Bush told the nation that "'unconscionable risk-taking, fraud, and outright criminality [were] factors' that led to the savings and loan crisis." Maureen Dowd, *Bush Savings Plan Calls for Sharing the Cost Broadly*, N.Y. Times, Feb. 7, 1989, at A1.

[8] For example, as of 1999, 25% of all individual trades were conducted on line. In 1994 not one person traded over the Internet. Many new Internet investors are inexperienced in any form of investing. Arthur Levitt, Remarks to National Press Club, Plain Talk About On-line Investing (May 4, 1999).

> an increase in abuses in the market for micro cap securities, which . . . provides opportunity for fraudsters to prey on innocent investors.

Fraud In The Micro-Capital Markets, Including Penny Stock Fraud: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs, 105th Cong. 114 (1997) (testimony of Arthur Levitt).

The Subcommittee Chair made a similar observation:

> We conduct these hearings against the backdrop of a booming stock market and a new generation of unseasoned investors. Hidden beneath the rising tide of the market, micro-cap fraud represents a pernicious undercurrent that potentially affects thousands of American families. Many of these families are, for the first time, investing their hard-earned money to save for skyrocketing tuition costs, unforeseen medical expenses, and lengthier retirements. While we have the safest and most successful capital markets in the world, the irony is that public confidence in our markets actually creates opportunities for con artists to exploit the unwary.

Id. at 55 (opening statement of Sen. Susan M. Collins).

Fraud is by no means limited to the micro-cap market, and the Senate hearing excerpts merely illustrate the problems faced by investors in many market sectors. For example, major brokerage houses peddled high risk limited partnerships, touting their suitability for conservative and older investors. *See, e.g., Coming to Terms, CSFB Agrees to Pay $100 Million to Settle Twin IPO Investigations,* Wall St. J., Dec. 11, 2001, at A1 (SEC announcing Credit Suisse First Boston will pay $100 million to resolve federal investigation into alleged abuses in distribution of its IPOs); *see also In re Prudential Sec. Inc. Ltd. P'ship Litig.*, 163 F.R.D. 200 (S.D.N.Y. 1995) (describing $110 million settlement with an

investor class growing out of Prudential's fraudulent marketing of 700 limited partnership units); *In re PaineWebber Ltd. P'ship Litig.*, 171 F.R.D. 104, 106 (S.D.N.Y. 1997) (approving $200 million settlement in action growing out of limited partnership sales). Fraudulent accounting practices remain a fertile source of Section 10(b) and Rule 10b-5 violations. *See In re Cendant Corp. Litig.*, 264 F.3d 286, 288 (3d Cir. 2001) (approving settlement for investor class of $2.85 billion in cash from the corporation and $335 million from Ernst & Young based on accounting fraud).

All of these practices can, and often do, wipe out savings accumulated during a person's lifetime for use during retirement. This underscores the importance of ensuring that investors victimized by these frauds can access the public and private enforcement mechanisms Congress provided for their benefit.

B. SEC Enforcement Actions & Private Lawsuits Are Powerful Tools Under The Exchange Act and Should Not Be Weakened

1. Congress Gave the SEC Broad Powers to Combat Fraud Under the Federal Securities Laws

The strength and stability of America's securities markets depend on investor confidence in the fairness and efficiency of the marketplace. Critical to maintaining this confidence is the availability of effective remedies against those who violate federal anti-fraud provisions. Congress recognized this need when it enacted Section 10(b) of the Exchange Act "'to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions[.]'" *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 296 (1993) (quoting *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986)). As the Second Circuit pointed out in *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964), compensating defrauded investors is another essential purpose

of the Exchange Act. In order to accomplish these goals effectively, the SEC's civil enforcement powers must remain as broad and flexible as possible.

The extensive hearings that preceded passage of the Exchange Act touched only briefly on Section 10, with most of the discussion devoted to the specifically enumerated devices the SEC would be empowered to proscribe under Section 10(a). The most relevant exposition of the provision that was to become Section 10(b) was provided by Thomas G. Corcoran, a spokesman for the drafters.

> "Subsection (c) [§ 9 (c) of H.R. 7852 - later § 10(b)] says, 'Thou shalt not devise any other cunning devices'. . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."

Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) (quoting *Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce*, 73d Cong. 115 (1934)). Very little has changed in this regard since 1934; the parameters of fraud differ only by the ingenuity of the perpetrators.

Section 10(b) and Rule 10b-5 are the core federal provisions that prohibit fraud against investors. The SEC, which promulgated Rule 10b-5 under its authority to enforce the federal securities laws, has stated that "Section 10(b) and Rule 10b-5 have come to embrace a diversity of claims which could not have been envisioned in 1934." Brief of *Amicus Curiae* SEC at 23, *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). In addition, a recent General Accounting Office ("GAO") report to Congress concerning staff turnover at the SEC described the agency's primary mission as protecting investors and maintaining the integrity of the securities markets and noted its responsibility for conducting investigations of potential securities law

violations and overseeing self-regulatory organizations, broker-dealers, mutual funds, investment advisors, and public utility holding companies. The GAO report stated that the "SEC's mission has become increasingly important as retail investors have become more involved in the securities markets . . . and as the markets themselves have begun to change, because of the increased use of alternative trading systems and the potential privatization of securities exchanges." U.S. General Accounting Office, Report to the Ranking Minority Member, Subcomm. on Financial Institutions, Senate Comm. on Banking, Housing, and Urban Affairs, "Securities and Exchange Commission: Human Capital Challenges Require Management Attention" 3-4 (Sept. 2001).

Justice Blackmun pointed out in *Aaron v. SEC* that Sections 17(a) of the Securities Act of 1933 and 10(b) of the Exchange Act are "the primary antifraud provisions of the federal securities laws. They are the chief means through which the Commission . . . can seek protection against deception in the marketplace. As a result, they are key weapons in the statutory arsenal for security market integrity and investor confidence." 446 U.S. 680, 704 (1980) (Blackmun, J., dissenting) (citations omitted). For example, the SEC's ability to compel a wrongdoer to disgorge its profits stems in large part from its authority to seek equitable relief in federal court. *See SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1103-04 (2d Cir. 1972) (upholding award of ancillary relief where court has authority to fashion appropriate remedy and "effective enforcement of the federal securities law requires that the SEC be able to make violations unprofitable"); *SEC v. Drexel Burnham Lambert, Inc.*, 956 F. Supp. 503, 507 (S.D.N.Y. 1997) (noting that restitution and disgorgement are distinct remedies – the former seeks to make the victim whole, the latter to deprive the wrongdoer of its ill-gotten gains).

2. The Fourth Circuit Erred in Holding That Zandford's Fraud Did Not Meet the "In Connection With" Standard and Thus Fell Outside the SEC's Broad Enforcement Authority

Zandford's fraud meets the "in connection with" standard required by Section 10(b). The Fourth Circuit's articulation of the issue reveals the flaw in its analysis. According to the court below, "[t]he question is not how Zandford stole the money in the Woods' account. Rather it is whether Zandford engaged in manipulation of a particular security." *SEC v. Zandford*, 238 F.3d at 565. Under Section 10(b) of the Exchange Act and related SEC Rule 10b-5, however, the pertinent question is whether Zandford employed a scheme to defraud in connection with the purchase or sale of a security. The SEC alleged that an integral part of the scheme in which Zandford had engaged to defraud the Woods involved the sale of securities. That is all the federal securities laws require; they do not require the manipulation of a particular security. Moreover, the Fourth Circuit labored under the misimpression that all securities fraud involves sophisticated schemes to manipulate the market for a particular stock. While this may occur in the majority of securities fraud cases brought in the district courts, neither Section 10(b) of the Exchange Act nor Rule 10b-5 contains such a requirement. Fraud actionable under those provisions can be committed with a bludgeon as well as a scalpel. In this case, Zandford used a bludgeon.

The federal securities laws prohibit *fraud* in connection with the purchase or sale of securities, and Zandford committed fraud, in part by selling securities. An examination of the statutory text at issue proves the point. Section 10(b) makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe . . . ." 15 U.S.C. § 78j(b). Pursuant to this statute, the SEC promulgated Rule 10b-5, which states it shall be unlawful for any person, by use of

interstate commerce, mail, or the facilities of any national securities exchange, "to employ any device, scheme, or artifice to defraud" or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. The plain language makes clear that neither the statute nor the rule requires the manipulation of a particular security, only a course of business that operates as a fraud in connection with the sale of a security. That is exactly what Zandford did in this case.

In finding that the "in connection with" requirement was not met in this case, the Fourth Circuit not only ignored the plain statutory and regulatory language, but also misapplied this Court's opinion in *United States v. O'Hagan*, 521 U.S. 642 (1997).[9/] In *O'Hagan*, the defendant had misappropriated a valuable piece of information and then purchased securities based on this stolen information. The theft and the purchase formed the scheme to defraud. Similarly, in this case, an unauthorized sale of securities was designed to generate proceeds for Zandford to misappropriate. These integrated acts -- the sale and the theft -- constituted the scheme to defraud, and that is all the statute and the rule require.

[9/] The Fourth Circuit's reliance on its decision in *Head v. Head*, 759 F.2d 1172 (4th Cir. 1985), is even more strained. In *Head*, the husband in a divorce proceeding listed certain stock (held only in his name) as an asset at book value (rather than market value). The wife never held an interest in the stock which, at one point, was placed in escrow to secure an obligation that the husband paid off in cash when the obligation came due. The wife later sued the husband for fraud in connection with the divorce settlement when he sold his stock at a price significantly higher than book value. The Fourth Circuit held that there never was a purchase or sale of stock, so any alleged fraud could not be "in connection with" the purchase or sale of a security. *Id.* at 1176.

3. The Fourth Circuit's Error Also Will Restrict Defrauded Investors From Seeking Redress Under the Federal Securities Laws

The Fourth Circuit's extremely narrow reading of the "in connection with" language will severely limit not only the SEC's enforcement authority, but also the rights of individual investors to seek redress under laws enacted for their benefit. The Court and the SEC repeatedly have cited the availability of private lawsuits as critical to effective enforcement of federal securities laws, and to maintenance of investor confidence in the integrity, fairness, and efficiency of the securities marketplace. For example, the Court stated that private actions provide "'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

The SEC has echoed this view. In testimony concerning litigation under the federal securities laws, Chairman Levitt stated:

> [T]he Commission has consistently stressed the importance of private actions under the antifraud provisions of the federal securities laws. In order to maintain investor confidence in the fairness of our securities markets, we must ensure that investors have a meaningful right to seek recovery against those who defraud them.

Securities Litigation Reform: Hearings Before the Subcomm. on Telecomm. & Finance of the House Comm. on Energy and Commerce, 103d Cong. 33 (1994) (testimony of Arthur Levitt).

The Director of the SEC's Division of Enforcement expressed similar sentiments:

> Due to the Commission's inability to address all violations, the implied private right of action under Section 10(b) and Rule 10b-5 thereunder is critically important to the effective operation of the federal securities laws. . . . Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetuate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection.

Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 103d Cong. 111, 113 (1993) (testimony of William R. McLucas).[10/]

[10/] While the industry often argues that Section 10(b) poses a particular danger of vexatious litigation, the Court and Congress already have addressed what were viewed as troubling aspects of Section 10(b) and significantly narrowed and clarified the law's reach. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976) (holding pleading scienter a requirement under Section 10b); *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723, 739 (1975) (permitting damages actions only by active market participants, i.e., purchasers and sellers); *Basic Inc. v. Levinson*, 485 U.S. 224, 249 (1988) (allowing a presumption of reliance under the fraud-on the market theory); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining materiality under an objective standard); *Lampf, Pleva Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361-62 (1991) (fixing a uniform statute of limitations for Section 10(b) actions); *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994) (holding private civil liability does not extend to those who aid or

The Fourth Circuit's error will have widespread consequences for individual investors, affecting private lawsuits as well as arbitration proceedings. Since 1987, the securities industry routinely includes pre-dispute arbitration clauses in its customer agreements.[11] Thus, individual broker-customer disputes only find their way to court in very limited circumstances. If arbitration is to provide a workable forum for recovery on meritorious investor claims and fulfill the purpose of the Exchange Act, the law which the arbitrators apply should be kept as clear as possible. While a bright line rule may be unavailable here, the meaning of "in connection with" that has been followed for years by the courts and arbitrators does provide some measure of certainty.[12] The lower court's articulation of the test narrows the meaning of the language and creates ambiguity. In fact, it is doubtful if the most common claims raised in arbitration,

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abet a violation of Section 10(b)); *see also* Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 747 (codified as amended in scattered sections of 15 U.S.C. § 78) (heightened pleading standards for private litigants and set new standards for class actions) and Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C. § 78) (precludes class litigants from seeking relief in state court to avoid heightened pleading standards of the PSLRA). Significantly, neither law touched the fundamental statutory scheme defining actionable conduct, including the "in connection with" language.

[11] *Shearson/American Express v. McMahon*, 482 U.S. 220, 238 (1987) (permitting pre-dispute broker-customer arbitration agreements to be enforced even where claims arise under Section 10(b)).

[12] *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 (1971) (upholding a Section 10(b) claim where the proceeds of a sale were misappropriated).

namely, churning and unauthorized trading,[13] even would be actionable under the Fourth Circuit's interpretation of "in connection with."

Furthermore, because a district court can only vacate an arbitration award if it finds "'manifest disregard of the law' or evidence," *Green v. Progressive Asset Mgmt., Inc.*, 2000 U.S. Dist. LEXIS 12428, at *4 (S.D.N.Y. Aug. 29, 2000) (quoting *Halligan v. Piper Jaffray, Inc.*, 148 F.3d 197, 202 (2d Cir. 1998)), it is particularly important to private litigants that the Court not insert a measure of ambiguity into years of precedent.

C. Neither A State Civil Remedy Nor A Criminal Proceeding Precludes a Claim Under the Federal Securities Laws

The Fourth Circuit found that Zandford's wrongdoing was more akin to a state law tort of conversion than a federal securities law violation. *Zandford*, 238 F.2d at 566. This comparison fails to recognize that the existence of a viable state civil claim or a related criminal proceeding does not bar the SEC or an individual from suing under the federal securities laws.

It is axiomatic that the existence of a remedy in state court does not preclude seeking a remedy for the same course of conduct under the federal securities laws. No lesser an authority than William O. Douglas stated that the difficulties of pleading a cause of action for fraud under state law led to passage of the Securities Act of 1933. *See* William O.

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[13] *See Krull v. SEC*, 248 F.3d 907, 908-909 (9th Cir. 2001) (charging churning and unauthorized trading of front end loaded mutual funds), and *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 323 (5th Cir. 1981) (stating that civil suits alleging excessive trading or "churning" in violation of brokers' common law fiduciary duty and the federal securities laws have dotted the federal docket).

Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 177 (1933) ("Satisfaction of the common-law requirements of fraud raised almost insurmountable barriers to recovery."). Congress enacted the federal securities laws in the 1930s because state law remedies were deemed inadequate to protect investors. *See* President Franklin D. Roosevelt, Regulation of Security Issues, Remarks to the Senate (Mar. 28, 1933), *reprinted in* 77 Cong. Rec. 937 (1933) (stating that "[i]n spite of many state statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities").

The federal securities laws are meant to co-exist with state laws, and the fact that both state and federal law may provide redress for the same wrongful conduct does not mean that only one or the other should be applied. In fact, in the *O'Hagan* case cited so prominently by the Fourth Circuit, the defendant was convicted of theft in Minnesota state court in addition to being prosecuted under the federal securities laws. 521 U.S. at 648 n.2; *see also Basic Inc. v. Levinson*, 485 U.S. 224, 245 n.22 (1988) (recognizing that actions brought under Section 10(b) are distinct from common law deceit and misrepresentation); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) (stating that actions under Section10(b) are designed, in part, to add to the protections provided to investors by the common law by establishing higher standards of industry conduct).

There are numerous examples of Congress enacting laws that co-exist with state laws that provide remedies for the same wrongful conduct. For example, in 1970 Congress enacted the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968. RICO provides a private treble damage remedy for predicate acts which are found to form a pattern of racketeering. Each of the predicate acts would, by definition, give rise to a state law claim. Nevertheless, despite state law or common law remedies for victims, Congress found that the 18th and 19th century jurisprudence available in state courts was ineffective in combating crime. *See* Organized Crime Control Act of 1970,

Pub. L. No. 91-452, 84 Stat. 922, 923 (statement of findings) (stating that "organized crime continues to grow . . . because the sanctions and remedies available to the Government are unnecessarily limited in scope and impact"); *see also United States v. Turkette*, 452 U.S. 576, 586 (1981) (providing that Congress enacted RICO because existing state law was inadequate to address problem).

Nor does the availability of criminal law enforcement preclude a civil action under the federal securities laws. Former Justice Robert Jackson observed that criminal law has "[l]ong proved futile to reach the subtler kinds of fraud at all, and [is] able to reach grosser fraud, only rarely." Robert Jackson, *The Struggle For Judicial Supremacy* 152 (1943). Criminal enforcement by state attorneys general or county prosecutors, by itself, is insufficient to deter securities fraud. Even coupled with criminal prosecutions by the United States Attorneys, and civil proceedings brought by the SEC and private plaintiffs, securities fraud has reached epic proportions, costing Americans billions of dollars annually. *See* Press Release, North American Securities Administrators Association, "Top 10 Investment Scams" List Released by State Securities Regulators, *supra*.

Federal, state, and local prosecutors do not have sufficient personnel to bring enough criminal cases to create an effective deterrent against fraud. The higher burden of proof in a criminal case alone makes civil enforcement actions under the federal securities laws an absolute necessity to deter securities fraud. Moreover, criminal prosecution often does not obtain restitution for victims, a critical remedy available to the SEC and investors under the federal securities laws. When Congress passed the Securities Act there was "so far as criminal law goes, a fair 'arsenal of weapons' to employ against subversive practices during the last decade. Yet little attempt was made to use them, and the failure can hardly be blamed solely upon limited state jurisdiction." William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. at 182.

If the SEC's enforcement authority is restricted to the point it cannot challenge such obvious fraudulent conduct in the sale of securities as occurred here, the investing public will have lost an invaluable safeguard and the SEC will have lost a critical weapon.

CONCLUSION

For all of the foregoing reasons, *amici* respectfully request that the Court reverse the Fourth Circuit and retain the federal securities laws as the powerful tools Congress intended.

December 26, 2001

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Supreme Court, U.S.
FILED
DEC 21 2001
CLERK

(9)

No. 01-147

IN THE

Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES ZANDFORD,
Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Fourth Circuit

BRIEF OF NASD REGULATION, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether a stockbroker's fraud is "in connection with the * * * sale" of securities under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5, when the stockbroker sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so.

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BRIEF OF NASD REGULATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

NASD Regulation, Inc. ("NASD Regulation") is the regulatory subsidiary of the National Association of Securities Dealers, Inc. ("NASD"), a private, not-for-profit corporation organized under the laws of Delaware. The NASD is a self-regulatory organization registered with the Securities and Exchange Commission ("SEC" or "Commission") as a national securities association pursuant to the Maloney Act of 1938, 15 U.S.C. § 78o-3 *et seq.* (amending Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78o *et seq.*).[1] The NASD "plays an important role in [the] complex self-regulatory scheme carefully set down by Congress." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363, 1368 (5th Cir. 1980). Congress, through the Exchange Act, has assigned the NASD the responsibility for conducting investigations and commencing disciplinary proceedings against member firms and their associated representatives to further compliance with the federal securities laws and NASD Rules. In 1996, the NASD created NASD Regulation as a wholly-owned subsidiary and delegated to it NASD's regulatory functions. Through its registration, examination, and disciplinary procedures, NASD Regulation operates as the first line of defense against fraud and misconduct in the federal securities markets.

The question presented in this case is whether a stockbroker violates Section 10(b) of the Exchange Act and Rule 10b-5 by trading his clients' securities without authorization

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief have been filed with the Clerk. Pursuant to this Court's Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amicus*, its members, or its counsel made a monetary contribution to the preparation or submission of this brief.

and misappropriating the proceeds of those transactions for his personal use. *Amicus* has a vital interest in correct resolution of that question because—as the "primary regulatory body for the broker-dealer industry" (*Sparta Surgical Corp. v. NASD*, 159 F.3d 1209, 1210 (9th Cir. 1998))—it has a significant stake in ensuring that the investing public is protected from such unscrupulous securities practices. In particular, *amicus* believes the decision below conflicts with this Court's precedents and creates a potential gap in the protection afforded to investors by the federal securities laws. NASD Regulation's authority to discipline NASD member firms and their associated persons for violating the federal securities laws is subject to significant limitations; its enforcement powers were intended only to complement the Commission's broad regulatory powers in this area. Because affirmance of the decision below could leave investors insufficiently protected against misconduct by securities traders, *amicus* respectfully submits this brief to assist the Court's consideration of the case.

STATEMENT

From 1987 to 1990, respondent Charles Zandford was employed as a stockbroker at Dominick & Dominick ("Dominick"), a brokerage firm located in Bethesda, Maryland. Pet. 27a. In September 1987, respondent convinced William R. Wood to open a joint investment account at Dominick. *Id.* The account was registered in Wood's name and in the name of his daughter, Diane Wood Okstulski. The stated objective for the account was "safety of principal and income." *Id.*

Wood made an initial deposit of $130,000 into the account in September 1987 and gave respondent an additional $289,000 to invest in March 1988. Pet. 27a-28a. The monies given to respondent by Wood constituted the entirety of Wood's life savings. Pet. 27a. At the time he opened the account, Wood was 71 years old and in poor health; his daughter, Okstulski, suffered from severe psychological disorders and was not competent to make independent financial

decisions. Pet. 27a-28a. In April 1988, Wood suffered a debilitating stroke and was thereafter hospitalized or cared for in a nursing home. Pet 28a. He died in 1991. *Id.*

Shortly after Wood's hospitalization in 1988, respondent began to perpetrate a financially devastating fraud on Wood and Okstulski. Pet. 28a-29a. On at least three occasions, respondent sold securities in a separate mutual fund account maintained by Wood and Okstulski and issued to himself checks that were drawn on that account. Pet. 28a. Respondent also sold securities in the Wood-Okstulski investment account and obtained a check from Dominick for the amount of the proceeds and deposited it into a bank account under his control. Pet. 29a. In addition, respondent drafted checks made payable to Wood and Okstulski and deposited them into accounts he owned and controlled. Pet. 29a. The cash used to honor those checks was generated by the sale of securities in either the mutual fund or joint investment account. Pet. 29a.[2]

By September 1990, respondent's deceptive scheme had completely depleted the value of the $419,000 that Wood had given respondent to "conservatively invest." Pet. 34a. Respondent used the proceeds from these various transactions for his own purposes, including the purchase of new cars, the payment of his credit card bills, and the purchase of securities and gifts for his girlfriend. Pet. 29a, 34a, 42a.

Respondent's fraud was first detected by the NASD pursuant to its self-regulatory duties during a routine examination of his employing firm, Dominick. *See* Pet. 34a. The NASD referred the matter to federal law enforcement authorities. In April 1995, a federal grand jury returned a su-

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[2] Respondent apparently had discretionary trading authority over the joint investment account. *See* Pet. 10a. Respondent has never contended, however, that such "discretion" authorized him to trade securities for his own benefit or to use the proceeds from those transactions for his personal use.

perseding indictment charging respondent with 13 counts of wire fraud in violation of 18 U.S.C. § 1343. The indictment alleged that respondent engaged in a scheme to defraud by "caus[ing] checks to be issued against the security positions of * * * Wood and * * * Okstulski made payable to [himself], thereby causing their securities to be liquidated." Pet. 41a. After a three-week trial, respondent was convicted on all counts and was sentenced to a prison term of 52 months. Pet. 35a. His conviction and sentence were affirmed on direct appeal and on collateral review. Pet. 33a-39a (direct appeal); *United States v. Zandford*, 181 F.3d 94 (4th Cir. 1999) (unpublished) (habeas).[3]

On September 26, 1995, petitioner Securities and Exchange Commission filed a civil complaint against respondent alleging violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. The complaint alleged that respondent violated those laws by engaging in excessive trading in the joint investment account, selling securities in Wood's ac-

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[3] The 1995 wire fraud conviction was not the first time petitioner encountered legal difficulties arising from his conduct as a broker-dealer. In 1987, the NASD initiated disciplinary proceedings against petitioner for misconduct he allegedly committed while working as a broker-dealer for Prudential-Bache Securities, Inc. ("Prudential"). Petitioner was found by the NASD to have improperly deposited personal funds into a customer's account and was fined and censured, but the Commission set aside that determination on appeal. *See In re Charles Zandford*, 50 S.E.C. 782, Release No. 29,901, 1991 WL 288257 (Nov. 5, 1991). Petitioner subsequently initiated a rash of civil suits against Prudential, NASD, and several of their respective employees. *See, e.g., Zandford v. NASD*, 30 F. Supp. 2d 1 (D.D.C. 1998) (dismissing complaint), *aff'd*, 221 F.3d 197 (D.C. Cir. 2000).

Petitioner also sued the NASD for its regulatory oversight activities concerning petitioner's securities trading at Dominick. *See, e.g., Zandford v. NASD*, 19 F. Supp. 2d 1 (D.D.C. 1998) (dismissing complaint); *Zandford v. NASD*, 19 F. Supp. 2d 4 (D.D.C. 1998) (same).

count without authorization, misappropriating $343,000 in proceeds, and using the money for his own purposes. Pet. 27a-30a.

The district court granted the Commission's motion for partial summary judgment on its misappropriation claims.[4] The district court reasoned that respondent's prior conviction for wire fraud "was based on the same facts alleged by the Commission against [respondent] * * * concerning misappropriations" and that the "criminal judgment of conviction established * * * all the elements * * * of [the Commission's] claims." Pet. 16a, 22a. Because respondent was "collaterally estopped" from "relitigating the facts underlying his conviction," and because the conduct which gave rise to respondent's conviction for wire fraud "has been consistently viewed by the SEC as a violation of Section 10(b) and Rule 10b-5," the district court concluded that respondent's scheme "violated the securities laws invoked" by the Commission "as a matter of law." Pet. 16a-17a, 22a. Significantly, the district court enjoined respondent from committing future violations of the securities laws and ordered him to pay disgorgement in the amount of $343,000. Pet. 22a.

The court of appeals reversed. Pet. 14a. The court of appeals rejected the district court's conclusion that collateral estoppel barred respondent from contesting his liability to the Commission, reasoning that the Commission's allegations under Sections 17(a) and 10(b) required proof that respondent "committed fraud 'in the offer or sale' of securities, or 'in connection with' the purchase or sale of securities," whereas "to find [respondent] guilty of wire fraud it was wholly unnecessary to determine whether his fraud was sufficiently connected to a securities transaction." Pet. 4a-5a

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[4] The Commission did not seek summary judgment on its allegations of excessive trading and did not object to the district court's entry of a "final judgment" in connection with its ruling on the summary judgment motion.

(citing 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5).

The court of appeals also rejected the district court's "legal conclusion" that the conduct for which respondent was convicted constituted a violation of the federal securities laws. Pet. 5a. To state a valid claim under Section 10(b) or Rule 10b-5, the court of appeals stated, the Commission was obliged to allege that respondent "influenced an[] investment decision by the Woods," "misled the Woods about the relative merits or value of particular securities," or "ma[d]e a[] reference to the attributes of a specific security." Pet. 9a-10a. Instead of meeting that standard, the court of appeals opined, the Commission's complaint alleged that "[respondent's] fraud lay in *absconding* with the proceeds of the sales," that any securities trades were merely "incidental" to respondent's scheme to "steal the Woods' assets," and that the Commission in effect had stated claims for "ordinary state law fraud or conversion" rather than "federal securities" violations. Pet. 7a-9a, 12a (emphasis added). Accordingly, the court of appeals reversed the grant of summary judgment for the Commission and remanded the case to the district court with instructions to dismiss the complaint.

SUMMARY OF ARGUMENT

The judgment of the court of appeals cannot be reconciled with this Court's cases construing Section 10(b) and Rule 10b-5, which make clear that the "in connection with" requirement is satisfied so long as a scheme to defraud has a relationship to or nexus with a securities transaction. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *United States v. O'Hagan*, 521 U.S. 642 (1997). Indeed, in *Bankers Life*, this Court squarely held that Section 10(b) encompasses cases in which the proceeds from a securities sale are improperly misappropriated, even if the execution of the securities sale itself was conducted at a fair market price and was not otherwise fraudulent. *Bankers Life*, 404 U.S. at 11. Because the Commission's complaint alleges that respondent sold securities without authorization from his clients in order to misappropriate the proceeds from those sales for his personal use, the Commission has plainly stated a violation of Section 10(b) and Rule 10b-5 under the teaching of *Bankers Life* and its progeny.

The decision below is also inconsistent with Congress's purposes in enacting the Exchange Act. The federal securities laws were adopted to protect investors from fraud and to bolster the public's confidence in the integrity of the securities markets. The decision below will undermine investor confidence and inhibit market participation by limiting the protective scope of Section 10(b) and Rule 10b-5.

The decision below also creates a potential gap in the protection afforded to investors by the federal securities laws. Although self-regulatory bodies can help regulate and deter misconduct by broker-dealers, the efficacy of those alternative enforcement mechanisms is subject to significant limitations. In the absence of oversight and enforcement by the Commission (under the aegis of Section 10(b) and Rule 10b-5 or otherwise), any unscrupulous elements in the broker-dealer industry will face fewer disincentives to engage in the type of improper securities practices that occurred here. For those reasons, the judgment of the court of appeals should be reversed.

ARGUMENT

THE COMMISSION HAS CLEARLY STATED A COGNIZABLE VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 UNDER SETTLED LAW

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device." 15 U.S.C. § 78j(b). SEC Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," "[t]o employ any device, scheme, or artifice to defraud." 17 C.F.R. § 240.10b-5. Because respondent defrauded Wood by selling the securities in the joint investment and mutual fund ac-

counts for his own benefit and without authorization, and misappropriated the proceeds from those transactions for his own purposes, his conduct satisfies the "in connection with" requirement of the Exchange Act and Rule 10b-5.

A. Respondent's Deceptive Scheme Was Executed "In Connection With" The Sale Of Securities

The Commission's complaint alleged that respondent improperly misappropriated proceeds from the joint investment account and mutual fund account by making checks drawn on those accounts payable to himself or by diverting checks drawn on those accounts that had been made payable to Wood and Okstulski. *See* Pet. 28a-29a. As the complaint alleges, the funds used to honor *all* of those checks were generated by unauthorized sales of securities in either the joint investment account or mutual fund account. *See id.* This Court's precedents make clear that those allegations are more than sufficient to state a violation of Section 10(b) of the Exchange Act and Rule 10b-5.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), this Court held that Section 10(b) applied to misconduct substantively indistinguishable from the conduct that respondent is alleged to have engaged in here. In *Bankers Life*, the defendants induced a company's board of directors to authorize the sale of Treasury bonds for fair market value and then misappropriated the proceeds of the sale for their own purposes. 404 U.S. at 9. Adopting an argument virtually identical to that presented by respondent here, the Second Circuit in *Bankers Life* had concluded that no claim under Section 10(b) was available because, "*with respect to the terms of the sale itself*[,] neither the purchaser nor the seller of the bonds was deceived or defrauded." 430 F.2d at 360 (emphasis added). The "fraud which harmed the plaintiff," the court of appeals stated, "consisted of the failure of [the defendants] *to account for the proceeds*" of the bond sale. *Id.* (emphasis added). Much like the Fourth Circuit in this case, the Second Circuit in *Bankers Life* opined that

"[t]here is a structural difference between *the sale* of the corporation's bonds"—conduct, the court of appeals acknowledged, that was regulated by the Exchange Act—and "the subsequent fraudulent misappropriation of the proceeds received" from the transaction, to which Section 10(b) did not apply. *See* 430 F.2d at 360 (emphasis added).

This Court rejected that reasoning in its entirety, deeming it "irrelevant" that "the proceeds of the sale" were "misappropriated." 404 U.S. at 10. What mattered, this Court stated, was not whether the actual *sale* of the bonds was legitimate, or whether a fair "market price was paid for th[e] bonds," but rather whether "the purity of the security transaction and the purity of the trading process were unsullied." *Id.* at 9-10 (citation omitted). As to that issue, this Court stated, "Section 10(b) must be read flexibly, not technically and restrictively" and should extend to injuries suffered "as a result of deceptive practices touching [the] sale of securities." *Id.* at 12-13. Because the board had been "duped into believing that it * * * would receive the proceeds," the Court concluded, the harm it suffered as a result of the misappropriation of the bond sale proceeds gave rise to a valid claim under Section 10(b). *Id.* at 9.

The facts alleged in the Commission's complaint are substantively indistinguishable from the claims at issue in *Bankers Life*. Like the corporate board in that case, Wood and Okstulski were "duped into believing that [they] * * * would receive the proceeds" of any securities transactions in their accounts. *Bankers Life*, 404 U.S. at 9. Similarly, as was the case in *Bankers Life*, the fact that funds may have been misappropriated from otherwise valid securities sales is "irrelevant" (*id.* at 10), because respondent's deceptive scheme sullied the "purity of the trading process." *Id.* at 10. Indeed, *Bankers Life* itself cited with approval a case holding that a broker violates Section 10(b) when he sells securities without client authorization and misappropriates the proceeds for his personal use. *See Bankers Life*, 404 U.S. at 11 n.7 (citing

Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 979 (S.D.N.Y. 1964)).[5]

The court of appeals attempted to distinguish *Bankers Life* on the ground that "the defendants made misrepresentations about a particular security that induced another party [to] * * * sell the security." Pet. 13a. But as both the Second Circuit and this Court recognized in *Bankers Life*, the misrepresentations at issue in that case had *nothing* to do with the attributes of the bonds at issue, or with the fairness of the sale of the bonds, but rather with the defendant's failure "to account for the proceeds" of the bond sale. 430 F.2d at 360. The court of appeals' attempt to distinguish *Bankers Life* is therefore entirely unavailing. *Bankers Life* controls this case, and the Court should follow it here. Neither party has called for *Bankers Life* to be overruled.[6]

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[5] The plaintiff in *Cooper* brought an action under Section 10(b) and Rule 10b-5 against a trust company and brokerage firm alleging that these defendants had orchestrated a scheme whereby stock the plaintiff had purchased and pledged to the trust company as collateral for a loan was sold by the brokerage firm without authorization and the proceeds misappropriated by the trust company, brokerage firm, and lender. *See* 226 F. Supp. at 974-75. Although there "[wa]s no wrongdoing alleged affecting the value of the stock" at the time it was purchased by the plaintiff or sold by the defendants (*id.* at 977), the district court denied the trust company's motion to dismiss, holding that Rule 10b-5 extends to cases in which the "plaintiff received his full value for the stock purchased" but "ultimately retained nothing as a result of the fraudulent" sale of the stock and misappropriation of the proceeds. *Id.* at 978. The district court noted that the SEC had "consistently viewed" cases in which "brokers who * * * sold a customer's stock and diverted the proceeds to their own pockets" as presenting violations of Section 10(b) and Rule 10b-5. *Id.* (citing SEC authorities).

[6] Leading commentators have uniformly concluded that "the 'in connection with' element as adumbrated by [*Bankers Life*] * * * require[s] some nexus but not necessarily a direct and close relationship between the fraud and the purchase or sale of a security." LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 963 (4th ed. 2001) (collecting authorities). They note that "courts have had no diffi-

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The decision below is also inconsistent with this Court's decision in *United States v. O'Hagan*, 521 U.S. 642 (1997). In that case, O'Hagan, a partner in a law firm, learned from colleagues about a proposed tender offer to be made by one of the firm's clients. 521 U.S. at 647-48. The partner traded on that information (by purchasing call options in the target's stock) without making any disclosure to the firm's client (or to anyone else). *See id.* When the government prosecuted him for committing a criminal violation of Section 10(b) and Rule 10b-5, O'Hagan claimed that his conduct, however improper, was not "fraud" committed "in connection with" the purchase or sale of securities. *See id.* at 650-57. This Court rejected that argument, holding that O'Hagan's conduct constituted a breach of fiduciary duty to the law firm's client, and that the breach was "consummated," not when the confidential information was obtained, but when "without disclosure to his [client], he use[d] th[at] information to purchase * * * securities." *O'Hagan*, 521 U.S. at 656.

The court of appeals recognized that *O'Hagan* "certainly expanded the scope of the in connection with requirement" (Pet. 11a), but concluded—as it did with respect to *Bankers Life*—that the case was not "control[ling]." Pet. 11a. According to the court of appeals, *O'Hagan* was inapposite because respondent, unlike O'Hagan, did not misappropriate any confidential information and because respondent's goal was not "to gain guaranteed profits through the purchase or sale of securities" but instead "simply to steal the Woods' assets." *Id.* at 12a.

O'Hagan, far from being distinguishable, completely forecloses respondent's attempt to evade liability under Sec-

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culty establishing the in connection with element in insider trading or *misappropriation cases*." *Id.* at 966 (emphasis added); *see also* 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 8.4 at 525 (2d ed. 2001) (same).

tion 10(b). Indeed, the case for liability under Section 10(b) and Rule 10b-5 is even *stronger* here than it was in *O'Hagan*. Respondent misappropriated from his clients not merely *information*, but their securities and the proceeds from the sale of those securities. Moreover, respondent deliberately deceived the actual owners of the securities in which he traded (*i.e.*, Wood and Okstulski), whereas O'Hagan's deception of his law firm did not affect any participants to his subsequent securities trades (*see O'Hagan*, 521 U.S. at 655 n.6). This case thus falls squarely within the rule of *O'Hagan*.

B. The Federal Interest In Protecting Investors Counsels In Favor Of Extending Liability To Respondent's Conduct

The decision below thus cannot be reconciled with this Court's precedents construing Section 10(b) of the Exchange Act and Rule 10b-5. Rather than adhere to the teaching of those cases, the court of appeals repeatedly described the Commission's claims as resembling "more a state law tort of conversion" or "more an actionable state law fraud than a federal securities violation." Pet. 10a, 12a. Invoking the truism that "Congress, in enacting the securities laws, did not intend to provide a federal remedy for all common law fraud" (Pet. 8a), the court of appeals concluded that "the goal of § 10(b) would *not* be served" by extending liability to the Commission's allegations against respondent. *Id.* (emphasis added).

The court of appeals' reliance on the congressional intent not to "subsume significant areas of state law" (Pet. 14a) is doubly flawed. First, it is well-settled that the federal securities were not enacted to proscribe *only* those fraudulent schemes that are not otherwise actionable at state law. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478 (1977) ("the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy"). To the contrary, Congress chose language in Section 10(b) that was deliberately expansive.

Rather than enact a statute making it unlawful to commit fraud "in a securities transaction," Congress proscribed fraud "in connection with" a securities transaction, because its aim was to prohibit not only garden-variety misrepresentations but also "unique," "novel," or "atypical" deceptive devices that securities traders might employ on unsophisticated investors. *Bankers Life*, 404 U.S. at 11-12. Indeed, Congress could not possibly have intended to proscribe only conduct that is not otherwise actionable under state law, given that in virtually every case of securities fraud, it is at least theoretically possible to reformulate the allegations as a breach of a state-law duty. Thus, although the court of appeals correctly observed that the "securities fraud provisions [do not] encompass *every* conversion or theft that happens to involve securities" (Pet. 14a (emphasis added)), it is equally true—and dispositive in this case—that if "fraud [is] used 'in connection with' [a securities transaction], there is redress under [Section] 10(b), *whatever might be available as a remedy under state law*." *Bankers Life*, 404 U.S. at 12 (emphasis added); *see also* 15 U.S.C. § 78bb(a).

Second, the court of appeals' analysis wholly ignores that Congress's *principal* purposes in enacting the Exchange Act were "to protect investors" (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976)) and to maintain "investors' confidence in the financial markets" (*Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982)). This Court has repeatedly recognized that "investor protection was a constant preoccupation of the legislators" (*United States v. Naftalin*, 441 U.S. 768, 776 (1979)), and that Congress sought to achieve that goal by "implementing a philosophy of full disclosure" (*Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988)), and by requiring "a high standard of business ethics * * * *in every facet of the securities industry*" (*Naftalin*, 441 U.S. at 775) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-87 (1963)) (emphasis in *Naftalin*).

Congress's twin purposes of "protect[ing] [investors] against fraud" (*Rubin v. United States*, 449 U.S. 424, 431 (1981)), and "promoting investor confidence" (*O'Hagan*, 521

U.S. at 644), would be seriously undermined by a rule placing a broker's unauthorized sales of a customer's securities and subsequent misappropriation of the sale proceeds outside the scope of Section 10(b) and Rule 10b-5. Brokers have become the informational and transactional gateway to the securities markets for large segments of the investing public, so much so that this Court has observed that "the welfare of investors and financial intermediaries are inextricably linked." *Naftalin*, 441 U.S. at 776. Indeed, fully two-thirds of individual investors in the United States now rely on the advice of professional financial advisers, including brokers, when making investment decisions. *See* INVESTMENT COMPANY INSTITUTE AND THE SECURITIES INDUSTRY ASSOCIATION, EQUITY IN AMERICA 7 (Fall 1999). Affirming the judgment of the court of appeals would erode investor confidence because customers undoubtedly will be reluctant to entrust their funds and investment decisions to brokers who play a central role in trading activity but against whom—under the court of appeals' decision—the Commission may have only limited remedies. Moreover, at least with respect to investor-broker relationships, such a rule would revive the very "philosophy of *caveat emptor*" (*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)), that Congress sought to eliminate with the Exchange Act.

To be sure, this Court has cautioned against the danger of construing the "in connection with" requirement so broadly as to make virtually any type of misconduct related to a securities transaction actionable under Section 10(b) and Rule 10b-5. *See, e.g., Santa Fe*, 430 U.S. at 478-79 (cautioning against a construction of Rule 10b-5 that would "bring within the Rule a wide variety of * * * conduct traditionally left to state regulation"). But the risk of overextending Section 10(b)'s scope is simply not presented by this case. All of the monies that respondent misappropriated were generated by respondent's unauthorized sales of his client's securities. Thus, whatever the outer boundary of Section 10(b) and Rule 10b-5 liability may be, respondent's conduct is well within that boundary, under this Court's precedents. Reversal of the decision below will "protect[] investors from fraudulent practices in the sale of securities" (*Naftalin*, 441 U.S. at 774), without "federaliz[ing] [a] substantial portion of [state] law * * * that deals with [such] transactions." *Santa Fe*, 430 U.S. at 463.

C. The Decision Below Creates A Potential Gap In The Protection Afforded To Investors In The Federal Securities Markets

Reversal also will eliminate the significant risk, created by the decision below, that the public will not be fully protected by the federal securities laws from the type of deceptive conduct in which respondent engaged here. In supplemental briefing before the court of appeals, respondent argued that self-regulatory organizations such as the NASD could effectively regulate misappropriation by brokers in the event the Commission did not have authority to police such misconduct under the aegis of Rule 10b-5. The court of appeals referred to those "professional sanctions" in reassuring itself that respondent would "face[] other forms of civil liability" for his misconduct. Pet. 13a. Respondent errs, however, in describing NASD proceedings as a fully adequate alternative to civil enforcement proceedings by the Commission. Although it is undoubtedly true that NASD Regulation would have authority to bring disciplinary proceedings against respondent for misappropriating his client's assets, NASD Regulation's powers to supervise and to punish violations of NASD rules and the federal securities laws were designed to *complement* the Commission's enforcement authority, not to *substitute* for it. Thus, NASD Regulation's regulatory and enforcement authority is more limited than either respondent—or the court of appeals—acknowledges.[7]

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[7] An overview of the self-regulatory scheme established by Congress for the securities industry can be found in *Silver v. New York Stock Exch.*, 373 U.S. 341 (1962); *Sparta Surgical Corp. v. NASD*, 159 F.3d 1209 (9th Cir. 1998); and *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363 (5th Cir. 1980). Examples of NASD Regulation's disci-

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NASD Regulation's enforcement mechanisms are limited to internal, administrative disciplinary proceedings. Unlike the Commission, NASD Regulation is not authorized to bring civil enforcement proceedings against securities violators. Instead, the tools at NASD Regulation's disposal include censure; the imposition of monetary fines and orders commanding disgorgement or restitution; and, for member firms, suspension or expulsion from NASD membership, or, for individuals associated with members firms, revocation of registration or bar from association with a member. *See* NASD Procedural Rule 8310. Those internal disciplinary remedies are applicable *only* to NASD member firms and persons associated with them. NASD Regulation has *no* jurisdiction over non-members, even if those individuals committed or aided and abetted a securities fraud. Indeed, NASD Regulation lacks subpoena power even over its own members (*see* NASD Procedural Rule 8210), and it has no direct authority to obtain information from third parties such as banks and other financial institutions that are subject to compliance with financial privacy laws, absent their voluntary cooperation.[8]

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plinary proceedings against brokers who misappropriate customer assets can be found in *Dist. Bus. Conduct Comm. v. Roach*, No. C02960031, 1998 NASD Discip. LEXIS 11 (Jan. 20, 1998), and *Dist. Bus. Conduct Comm. v. Bavero*, No. C9A920035, 1993 NASD Discip. LEXIS 227 (Sept. 7, 1993).

[8] As a private entity, NASD Regulation does not have subpoena authority. However, NASD Procedural Rule 8210 gives staff authority to:

> (1) require a member, person associated with a member, or person subject to the Association's jurisdiction to provide information orally, in writing, or electronically * * * if requested, with respect to any matter involved in the investigation, complaint, examination, or proceedings; and

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The Commission, by contrast, is empowered to initiate civil enforcement proceedings that subject defendants to compulsory process and the powers of the federal judiciary. Consistent with the Federal Rules of Civil Procedure, the Commission can enforce deposition and document subpoenas issued to defendants and third parties. Institution of civil proceedings also provides the SEC with important mechanisms for obtaining interim relief while charges are pending, including preliminary injunctive decrees and temporary restraining orders. *See* FED. R. CIV. P. 65. NASD rules provide no equivalent provisional remedies during NASD Regulation's disciplinary proceedings.[9] Moreover, the Commis-

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> (2) inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation, complaint, examination, or proceeding.

NASD Procedural Rule 8210. Failure to comply with a request for information may subject a member or person associated with a member to disciplinary proceedings and possible sanctions. All persons registered with the NASD agree as a condition of their registration to comply with all NASD rules and regulations, including Rule 8210. NASD Bylaws, art. IV, § 1; art. V, § 2.

[9] On December 13, 1998, the NASD proposed for comment an amendment to its rules that would increase NASD Regulation's administrative authority over its members but still would not give NASD Regulation the same powers as the SEC. The proposal would authorize NASD Regulation to issue temporary cease and desist orders against NASD members in certain, limited circumstances. *See Notice Of Filing Of Proposed Change And Amendment No. 1 Thereto By The National Association Of Securities Dealers, Inc. Relating To The Issuance Of Temporary Cease And Desist Orders*, 63 Fed. Reg. 71,984 (December 30, 1998). Failure to comply with an administrative cease and desist order would authorize NASD Regulation to suspend or expel NASD member firms or to revoke the registration of their associated persons. *Id.* at 71,990. The proposed rulemaking explains that "there is a clear need for an additional tool to stop members' or associated persons' misconduct that causes significant dissipation of or conversion of assets or other significant harm to

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sion is empowered to seek injunctions to prevent threatened violations of the securities laws, but NASD Regulation has no comparable power. Indeed, NASD Regulation must rely on the Commission to seek injunctions to prevent violations of NASD rules. *See* 15 U.S.C. § 78u(e); *Lang v. French*, 154 F.3d 217, 220 (5th Cir. 1998).

The Commission also has much broader authority to *enforce* its orders than does NASD Regulation. The failure to comply with a court order or judgment in an SEC enforcement proceeding may subject parties to civil and possibly criminal contempt proceedings, in which substantial fines and even imprisonment can be imposed. *See, e.g., Ex parte Robinson*, 86 U.S. (19 Wall.) 505, 510 (1874) ("The power to punish for contempts is inherent in all courts; its existence is essential to the preservation of order in judicial proceedings, and to the enforcement of the judgments, orders, and writs of the courts, and consequently to the due administration of justice."). By contrast, NASD Regulation's authority to punish noncompliance with its disciplinary sanctions is limited to the power to expel member firms and associated members from NASD membership—a power the Commission also possesses. NASD Regulation has no independent authority to enforce its disgorgement or restitution awards in federal court and (absent action by the Commission) must instead file state-court actions that seek to enforce those orders on a

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investors while a disciplinary action is pending." 63 Fed. Reg. at 71,987. The proposal explains that "under the NASD's current rules, it takes a minimum of four months to complete a disciplinary proceeding" and that existing provisions governing the summary suspension of members apply only to failures to pay dues, fees, assessments, or other charges, or to failures to comply with an arbitration award, and cannot be invoked "to stop ongoing, violative conduct while an underlying disciplinary proceeding is being litigated." *Id.* at 71,987-88. The proposed rule remains under review by the Commission and, as noted above, the rule, even if adopted, would not alleviate the enforcement problems identified in the text.

contract theory. Indeed, unlike the SEC, NASD Regulation has *no* authority to subpoena banks, credit card companies, or other financial institutions to obtain information about a broker's assets in order to enforce a restitution award.

Thus, although NASD Regulation has the mandate and the authority to discipline NASD members and associated persons for violations of the federal securities laws and NASD rules, its disciplinary authority is different *in kind* from the SEC's civil enforcement authority. As a private nongovernmental organization, NASD Regulation lacks many of the powerful enforcement tools that are available to the Commission. *See Ernst & Ernst*, 425 U.S. at 195 (noting that Congress provided the Commission "with an arsenal of flexible enforcement powers"). Oversight by NASD Regulation is undoubtedly the critical, first line of defense in policing fraud in the federal securities markets. But the self-regulatory scheme is not a substitute for the powers of the Commission to police fraud under Section 10(b) and Rule 10b-5. Respondent is therefore incorrect in suggesting that any "enforcement gap" resulting from a narrow interpretation of Section 10(b) and Rule 10b-5 will be addressed by self-regulation.

The practical consequence of the decision below will be that similar frauds will be much more difficult to deter and to punish. Although such conduct could still be prosecuted as a violation of the mail or wire fraud statutes, neither the Commission nor NASD Regulation can bring actions under those statutes, and the Department of Justice cannot realistically be expected to prosecute all such violations. Moreover, it has long been recognized that Section 10(b) and Rule 10b-5 are "more effective than the Mail [and Wire] Fraud Statute[s]" precisely because "Congress has given the SEC the long-range weapon of injunction with which to combat threatened or continuing violations of [those provisions]." Alexander H. Frey, *Federal Regulation of the Over-the-Counter Securities Market*, 106 U. PA. L. REV. 1, 16 (1957). The decision below thus eliminates a crucial protection for investors in the securities markets and over the long run will harm investor

confidence and invariably lead to other frauds similar to those perpetrated by respondent.

CONCLUSION

The court of appeals erred in remanding the case to the district court with instructions to dismiss the Commission's complaint. As alleged by the Commission, respondent's deceptive scheme was plainly executed "in connection with" the sale of securities, and under this Court's precedents gives rise to a valid claim for relief under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. Moreover, the court of appeals' interpretation of the statute threatens to undermine investor confidence and to create a regulatory gap in the congressional scheme for overseeing the securities industry. The judgment of the court of appeals should be reversed.

Respectfully submitted.

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December 21, 2001